

***United States Court of Appeals
for the Second Circuit***



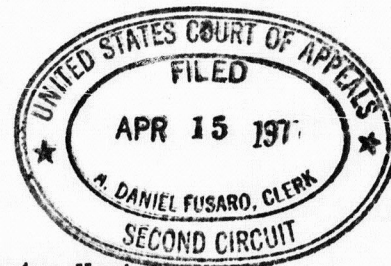
**APPELLANT'S
BRIEF**

77-7060

To be argued by
ANTHONY L. TERSIGNI

United States Court of Appeals

FOR THE SECOND CIRCUIT



HOWARD M. LASKER and IRVING GOLDBERG,

Plaintiffs-Appellants,

—against—

HARRY G. BURKS, JR., EDWARD B. BURR, THOMAS F. CHALKER, JOHN R. HAIRE,
HARVEY C. HOPKINS, S. P. HUTCHISON, DONALD L. KEMMERER, A. S. MIKE
MONRONEY, CHARLES F. PHILLIPS, JEPHTHA H. WADE, ANCHOR CORPORATION
and FUNDAMENTAL INVESTORS, INC.,

Defendants-Appellees.

ON APPEAL FROM ORDERS AND JUDGMENT OF THE UNITED STATES
DISTRICT COURT FOR THE SOUTHERN DISTRICT OF NEW YORK

APPELLANTS' BRIEF

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Plaintiffs-Appellants,	:
-against-	:
HARRY G. BURKS, JR., EDWARD B. BURR,	:
THOMAS F. CHALKER, JOHN R. HAIRE,	:
HARVEY C. HOPKINS, S. P. HUTCHISON,	:
DONALD L. KEMMERER, A. S. MIKE MONRONEY,	:
CHARLES F. PHILLIPS, JEPHTHA H. WADE,	:
ANCHOR CORPORATION and FUNDAMENTAL	:
INVESTORS, INC.,	:
Defendants-Appellees.	:

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APPELLANTS' BRIEF

Preliminary Statement

This action is brought by two shareholders on behalf of a mutual fund, Fundamental Investors, Inc.* The claims asserted involve investment losses of \$20 million. The complaint alleges gross misconduct, abuse of trust and fraud by the Fund's investment adviser, Anchor Corporation, and certain of the Fund's present and past directors.

The essence of the charge against Anchor is that it failed, despite readily observable danger signals, to conduct any research or investigation whatsoever concerning the financial stability of the now bankrupt Penn Central Transportation Company or

* Judge Henry F. Werker is the district court judge from whose orders and judgment this appeal is taken. Two of the decisions below are reported at 404 F. Supp. 1172 (S.D.N.Y. 1975) and CCH Fed. Sec. L. Rep. ¶95,832 (S.D.N.Y. 1977).

the creditworthiness of its commercial paper, either before or after causing the Fund to purchase it, but relied instead on the recommendation of the dealer selling the paper for its own account, Goldman, Sachs & Co. Anchor also violated its own internal guidelines in connection with the purchases.

The Fund's directors are charged with abdicating their responsibilities by failing to supervise Anchor's activities, by remaining oblivious to the procedures being used and the specific nature of the purchases being made and by failing to control the Fund's basic investment policies.

The district court, specifically declining to review the merits of appellants' claims, dismissed the action on the ground, in substance, that a disinterested minority of the Fund's board (five of eleven) had determined in their business judgment, two years after commencement of the action, that the litigation should be terminated. The selection process by which the minority directors were nominated for their directorships was created, implemented and controlled by appellees. It was also appellees who initiated and delegated to the minority the question of what action should be taken by the Fund regarding this litigation.

Appellants contend that the cloak of the business judgment rule is not available as a bar to the prosecution of this action. The procedure sanctioned below, whereby appellants' claims were dismissed outright at the instance of a minority of a controlled board two years after the action had commenced, is

unprecedented and, if allowed to stand, would become a new and potent weapon for the frustration of important prophylactic legislation. It would open wide the door for abuse, would inevitably foster the denial of justice and would negate even the appearance of justice. Appellants believe that the result below therefore warrants the closest scrutiny by this Court.

Statement of the Issues

1. As a matter of law, can the business judgment of the minority directors of the regulated mutual fund on whose behalf the present action is brought properly bar further prosecution of the action?
2. If so;
 - (a) did the minority directors have full and adequate disclosure?
 - (b) were the minority directors truly independent?
 - (c) may this action be dismissed without discovery on the merits and judicial review of the merits?

Statement of the Case

Fundamental Investors, Inc. (the "Fund") is an open-end mutual fund, one of seven funds within the Anchor Group of Mutual Funds (133A, 136A).^{*} Anchor Corporation ("Anchor") is the Fund's investment adviser (216A). The individual appellees are the directors who were members of the Fund's board at the time of the acts complained of (7A).

^{*} This and similar references are to the Joint Appendix.

While there has as yet been no discovery on the merits, the record nevertheless reveals the following:

During the period November 28 through December 8, 1969, the Fund purchased, in four separate transactions, \$20 million worth of 270-day Penn Central commercial paper (56A, 61A, 62A). The paper was purchased from Goldman, Sachs & Company, which Anchor believed had conducted a credit analysis of the issuer (62A-63A). Goldman, Sachs sold the paper as a principal out of its own inventory (61A). Notwithstanding its duty, as a highly paid adviser, to render independent advisory recommendations, Anchor concededly did not conduct any independent analysis or investigation, either at the time of purchase or thereafter (63A, 74A).

In mid-May 1970 Anchor became concerned about the safety of commercial paper generally and sought to reduce the Fund's Penn Central holdings by one-half (63A-64A). However, Goldman, Sachs refused to buy back any of the paper (64A). On June 21, 1970 Penn Central filed its petition in bankruptcy (64A). The paper was not paid at maturity (64A).

In November 1970 the Fund and three other parties sued Goldman, Sachs in connection with their purchases of Penn Central paper. The complaint alleged various misstatements and omissions of fact by Goldman, Sachs in connection with the purchases (64A).

In February 1973 appellants, as shareholders of the Fund, commenced this action against Anchor and the Fund directors. The complaint asserts violations of Section 36 of the Investment Company

Act and alleges conduct and practices constituting gross misconduct and gross abuse of trust. Anchor is charged with having abdicated its independent advisory responsibilities. The Fund's directors are charged with having permitted that abdication. Anchor is also charged with violating Section 206 of the Investment Advisers Act on the ground that its conduct operated as a fraud on the Fund. All defendants are charged with violating Section 13(a)(3) of the Investment Company Act by causing the Fund to deviate from a fundamental policy recited in its registration statement by holding more than 10% of the outstanding securities of a single issuer. Finally, all defendants are charged with breach, or aiding and abetting a breach, of Anchor's investment advisory contract and with breach of their common law fiduciary duties (14A, 15A, 18A, 19A, 20A).

Defendants have never answered the complaint. They applied for and Judge Gurfein granted a stay of this action pending the determination of the action against Goldman, Sachs. However, defendants were required by Judge Gurfein, as a condition to the stay, to file waivers of the statute of limitations (2A, 3A).

On or about July 9, 1974 the Fund settled its claims against Goldman, Sachs for \$5-1/4 million plus an interest in the potential proceeds of Penn Central's bankruptcy (197A). Defendant John R. Haire, president of the Fund and chairman of the board of Anchor, and Mr. Roger T. Wickers, an officer of both the Fund and Anchor, concluded that since the Fund at that time had five

directors who were neither defendants in the present action nor affiliated with Anchor, these five, constituting a quorum, albeit a minority of the board, could, under the Fund's charter and by-laws, act for the Fund in determining what position it should take with respect to the present action (399A). These five minority directors had been selected and nominated for their directorships pursuant to a procedure initiated, implemented and controlled by defendants (174A-185A, Document 84 of Index to Record, Pls. Exhs. 13, 14, 21 and 22).

Haire instructed Wickers to explore the possibility of retaining special counsel, which he did. Wickers ascertained that former Chief Judge Stanley H. Fuld would be available (404A-405A). At a board meeting on July 24, 1974, Wickers presented to the directors the proposal for a "disinterested quorum" and suggested several names as possible special counsel, indicating that Judge Fuld was available (198A, 704A-705A, 718A -719A). The minority directors agreed to look into the matter and instructed Wickers to contact Judge Fuld and request that he review the case (198A).

Judge Fuld rendered a report on December 5, 1974 and a supplemental report on December 18, 1974 (56A-102A). He concluded, on the basis of the information and authorities available to him, that neither Anchor nor the Fund's directors had any liability under federal or state law (57A). However, Judge Fuld's opinion was expressly qualified. He repeatedly referred to what he believed to be the absence of legal authority on the issue of whether a

mutual fund's investment adviser is required to conduct independent research in connection with its investment recommendations (77A, 80A-81A, 83A). He also cautioned that "difficult questions of fact and law" were involved (95A) and that it was "impossible for one to predict what...a trier of fact will find, particularly in complex circumstances" (84A).

The minority directors met on December 18, 1974 and again on January 6, 1975, at which time they adopted a resolution directing litigation counsel for the Fund to seek dismissal of this action (103A, 125A, 131A). The Fund, joined by all other defendants, subsequently moved to dismiss the action based on the business judgment of the minority directors that further prosecution of this action would not be in the best interests of the Fund's shareholders (33A-34A).

The district court held that the minority directors had the power, as a matter of law, to exercise business judgment barring any further prosecution of the present action, provided they were truly disinterested and independent (148A, 152A). The court found, however, that a factual issue had been raised concerning the actual independence and disinterestedness of the minority directors and granted discovery on that limited issue (152A-153A). Following discovery, defendants renewed their motion and the district court

dismissed the action, holding that there was no showing that the minority directors were not truly disinterested and independent (1149A-1150A). Judgment of dismissal was entered on January 17, 1977 and this appeal followed (1155A, 1156A).

Argument

POINT I

THE RESULT BELOW (1) IS INCONSISTENT WITH THE STRONG POLICY CONSIDERATIONS WHICH HAVE NECESSITATED THAT A PRIVATE RIGHT OF ACTION BE IMPLIED UNDER SECTION 36 OF THE INVESTMENT COMPANY ACT AND SECTION 206 OF THE INVESTMENT ADVISERS ACT AND (2) VIOLATES BOTH THE LETTER AND SPIRIT OF SECTION 17(h) OF THE INVESTMENT COMPANY ACT.

The Relevant Policy Considerations

Both the Investment Company Act and the Investment Advisers Act were enacted in 1940 as part of a comprehensive regulatory network to protect the investing public from grave abuses in the investment company industry. Brown v. Bullock, 194 F. Supp. 207, 223, 233 (S.D.N.Y.), aff'd, 294 F.2d 415 (2d Cir. 1961). The 1933 and 1934 federal securities laws had been found inadequate to cope with the managerial abuses endemic to, and prevalent among, mutual funds and their advisers (Id. at 217, 233). This Court has recently observed that the management of mutual funds "is fraught with potential conflicts of interest" and that

"'self-dealing is not the exception but, so far as management is concerned, the order of the day.'" Galfand v. Chestnutt, 545 F.2d 807, 808 (2d Cir. 1976); Tannenbaum v. Zeller, CCH Fed.Sec.L.Rep. ¶95,900 at 91,327 (2d Cir. 1977).

By means of the 1940 legislation, Congress placed the entire operation and management of the mutual fund industry under specific and comprehensive regulation.

"In certain major respects, the 1940 Act operates as a corporation law for investment companies. . . . In light of the distinctive character of investment companies and their easy susceptibility to management abuses. . . , one of the primary objectives of the 1940 Act was the protection of investment companies as well as investors against the derelictions of investment companies' directors, investment advisers, other fiduciaries, and principal underwriters." Brown v. Bullock, supra at 232-33.

Against this backdrop of strong prophylactic congressional policy, the courts, and this Court in particular, have consistently held that the 1940 legislation, including Section 36 of the Investment Company Act and Section 206 of the Investment Advisers Act, gives rise to implied private rights of action in favor of aggrieved shareholders of investment companies. See, for example, Abrahamson v. Fleschner, CCH Fed.Sec.L.Rep. ¶95,889 (2d Cir. 1977); Galfand v. Chestnutt, supra; Fogel v. Chestnutt, 533 F.2d 731 (2d Cir. 1975), cert. denied, ___ U.S. ___; Rosenfeld v. Black, 445 F.2d 1337 (2d Cir. 1971), cert. dismissed, 409 U.S. 802 (1972); Moses v. Burgin, 445 F.2d 369 (1st Cir. 1971), cert. denied, 404 U.S. 994 (1971); Brown v. Bullock, supra. The rationale underlying these holdings was set forth in Brown v. Bullock, supra at

246:

"[A] denial of a private right of action to those for whose ultimate protection the legislation is intended leaves legislation highly publicized as in the public interest in fact sadly wanting, and even delusive, to that end."

And in Abrahamson v. Fleschner, supra at 91,275, this Court stated:

"In enacting the 1940 legislation, Congress intended to provide effective federal regulation of an important segment of the securities industry. Failure to recognize a private right of action under the Advisers Act would effectively frustrate that purpose."

This Court noted in Abrahamson that the Securities and Exchange Commission had insufficient resources for full and effective enforcement of these laws and therefore:

"Absent judicial recognition of private rights of action, the federal securities laws most assuredly would fail to provide the effective regulation over the securities industry which Congress intended" (Id. at 91,274).

Thus, if the comprehensive prophylactic legislation Congress intended upon passage of the Investment Company Act and Investment Advisers Act is to be enforced to any meaningful degree, private rights of action must be permitted and so construed that injured parties are given their day in court and an opportunity to vindicate their rights. Certainly, there is no reason to interpret an implied right of action in a manner which defeats the right and, with it, the congressional purpose - - and every reason for the contrary result.

"It is a hornbook maxim, based upon bedrock policy considerations, in a society founded upon individual rights, that where a duty has been created by statute for the benefit of a special class, a member of that class may maintain a private action to enforce the duty." Walsh and Levine v. Peoria and Eastern Ry. Co., 222 F. Supp. 516, 519 (S.D.N.Y. 1963).

Appellants in the present case are members of the very class of shareholders for whose protection the 1940 legislation was enacted. They, not the Fund's managers, are the persons most vitally interested in effective enforcement of the laws in question. The Fund's managers, on the other hand, are the very persons whose conduct Congress sought to regulate. It would defy logic and undermine the purpose of the statutes for regulated directors to have sole discretion, to the exclusion of the shareholders, in determining when and whether prohibitions against gross misconduct by fiduciaries, gross abuse of trust and fraud are to be enforced. That, in sum, is the position put forward by appellees and one which is repugnant to the purposes of the 1940 legislation. If a private remedy must be implied to protect shareholders of mutual funds, like appellants, that implied remedy should not be so hedged by "business judgment" that it is rendered meaningless.

In Papilsky v. Berndt, 503 F.2d 554 (2d Cir. 1974), cert. denied, 419 U.S. 1048 (1974), arising under various sections of the Investment Company Act, including Sections 1(b), 17(h) and 36, the issue was whether the denial of a motion to dismiss based on a plaintiff shareholder's failure to make a demand on the board of directors was appealable. This Court held it was not, stating:

"The collateral right claimed to be destroyed, i.e., the right to have the board of directors exercise its independent business judgment on whether to sue before permitting a stockholder to bring suit, is not of sufficient magnitude to permit an interlocutory appeal
[T]he right is not of great magnitude for the reason that, if (as might well be anticipated) a majority of the board refuses to sue, plaintiffs presumably would then be permitted to reinstitute their present action"
(Id. at 556) (Emphasis added).

The Court assumed as obvious that the business judgment of the directors could not bar the action from going forward. In addition, if the alleged right of independent business judgment is not even of sufficient magnitude to justify an interlocutory appeal, it certainly cannot be accorded such great magnitude as to frustrate enforcement of congressionally mandated fiduciary standards and to warrant the denial of a day in court to public shareholders Congress sought to protect. See also Baffino v. Bradford, 57 F.R.D. 79, 81 (D. Minn. 1972) ("Absent action by the Directors, the plaintiff may renew her action.").

Section 17(h)

Even apart from the above considerations, the result below violates both the letter and spirit of Section 17(h) of the Investment Company Act. Section 17(h) provides:

"[N]either the charter, certificate of incorporation, articles of association, indenture of trust, nor the by-laws of any registered investment company, nor any other instrument pursuant to which such a company is organized or administered, shall contain any provision which protects or purports to protect any

director or officer of such company against any liability to the company or to its security holders to which he would otherwise be subject by reason of willful misfeasance, bad faith, gross negligence or reckless disregard of the duties involved in the conduct of his office."

In Brown v. Bullock, supra, the court said of this provision:

"An attempt to immunize a possible violator of the statute against liability for his violation was deemed by Congress to be so offensive as to be stricken down as void ab initio" (194 F. Supp. at 237).

Defendants' motion in the court below was premised on the quorum provisions of the Fund's charter and by-laws whereby a quorum consisting of not less than one-third of the members of the board of directors may act for the full board (Section 1 of Article Eight of the Certificate of Incorporation and Section 4 of Article Six of the By-Laws) (141A, 154A). Thus, Mr. Kendall's moving affidavit stated:

"The Board of Directors determined that the five directors who (a) are not affiliated in any way with the investment adviser, Anchor Corporation ("Anchor"), (b) were not directors at the time of the events alleged in the complaint and (c) are not defendants in this action ("the five disinterested directors") would, acting as a quorum pursuant to the by-laws, constitute the Board of Directors to decide what position Fundamental should take regarding this action" (Emphasis added) (39A-40A).

(See also Document 63 of Index to Record, pages 10-12). On the purported basis of authority derived from the Fund's charter and by-laws, five members of an eleven-member board passed a

resolution seeking the dismissal of this lawsuit, the effect of which is the protection, if not the complete exoneration, of their fellow directors and the investment adviser from liability for gross misconduct and abuse of trust. To give effect to that resolution and the interpretation of the Fund's charter and by-laws on which it is based is to ignore Section 17(h).

This Court has previously struck down an attempt by a fund manager to protect itself from liability in a manner far more modest than the complete exoneration which has been attempted here. In Chabot v. Empire Trust Co., 301 F.2d 458 (2d Cir. 1962) a shareholders' derivative action was brought against the trustee of a fund and its investment adviser for excessive fees, charging, as in the present case, gross abuse of trust. The defendants moved to stay the action pursuant to a clause in a trust agreement requiring the shareholders to post security for litigation costs and legal fees. This Court struck down that requirement as violative of Section 17(h). In response to defendants' contention that Section 17(h) had not been violated because the provision for costs did not purport to exculpate the trustee from liability, the Court stated:

"This argument flies in the face of the statutory language which speaks of protection rather than exculpation, but even if we were to accept appellee's position we would, of course, insist on examining substance rather than form in determining whether such a contractual clause had the effect of exculpation" (Id. at 461).

* * *

"It is our view that any provision that renders litigation substantially less likely 'protects or purports to protect' directors and officers from liability under the Act" (Ibid).

In the present case, of course, by means of the quorum provisions relied upon, appellees not only seek to render the litigation less likely, they seek to terminate it altogether.

In construing Section 17(h), this Court also referred in the Chabot case to Section 1(b) of the Investment Company Act, which states as a "declaration of policy":

"'the national public interest and the interest of investors are adversely affected * * * when investment companies are organized, operated, [or] managed * * * in the interest of directors, officers, [or] investment advisors * * * [and] when investment companies * * * are not subject-
ed to adequate independent scrutiny'" (Id. at 461-62) (Emphasis added) (Asterisks and bracketed words by the Court).

The Court added:

"The same section instructs the courts to interpret the provisions of the act in a manner that will 'mitigate, and, so far as is feasible, * * * eliminate the conditions enumerated in this section. . . .'" (Id. at 462).

The Court noted further:

"The Act was designed to 'provide safeguards without undue restriction, so that those who desire to put their savings to work in this manner may do so with greater confidence'" (Ibid.) (Emphasis added).

In the present case, defendants' efforts to terminate this litigation are a blatant attempt to protect themselves from

liability at the expense of the shareholders by cutting off independent judicial scrutiny of their misconduct in violation of the provisions and policies of the Investment Company Act as interpreted by this Court in Chabot. This is an unprecedented attempt by the managers of an investment company to bar judicial scrutiny of breaches of fiduciary duties arising under the Act. If successful, it would undermine effective enforcement of that legislation, as well as contravene the requirement of "adequate independent scrutiny" articulated by this Court.*

In the Chabot case, the trustee also argued that the provision for costs was legitimate because it protected the fund, and ultimately the shareholders, from the expense of defending allegedly frivolous actions. Similarly, in the present case the minority directors have taken the position that appellants' claims are without merit and that the Fund and its adviser ought not to be put to the burden and expense of a nonmeritorious lawsuit (47A-49A). The Court in Chabot responded:

"[S]tockholder actions provide that 'adequate independent scrutiny' of investment companies to which the Act refers, and thereby tend to deter violations of the Act and of the common law duties of such companies. By the enactment of §17(h) Congress has expressed its judgment that the latter is the weightier concern -- that unscrupulous management presents a greater danger to the financial interests of the shareholders than do unfounded shareholder actions. It is not for this court to reweigh that judgment" (Ibid.)

* See also Miller v. American Telephone & Telegraph Co., 507 F.2d 759 (3d Cir. 1974), in which an attempt by directors to prevent shareholder litigation challenging the validity of campaign contributions was rejected.

In this regard, the Fund's own charter recognizes and implements in a particular context the principles of shareholder protection and adequate independent scrutiny embodied in Sections 1(b) and 17(h) of the Investment Company Act. Article "Twelfth" of the Fund's certificate of incorporation provides in substance that, absent a finding of liability, directors and officers under certain conditions may be indemnified for expenses incurred in connection with litigation. If the directors are not wholly absolved from liability by the litigation, or if the case is settled, then two-thirds of the directors not involved in the litigation must determine that the defendant directors are not liable. If a majority of the directors are involved in the litigation, as here, then the minority directors must obtain the written opinion of independent counsel that the directors were not guilty of negligence or misconduct. Absent a judicial finding of non-liability on the merits, however, neither the determination of the directors nor that of independent counsel

"shall ... prevent a stockholder from challenging such indemnification by appropriate legal proceedings on the grounds that the person indemnified was liable to the Corporation or its security holders by reason of such negligence or misconduct" (192A-193A).

Thus, neither the business judgment of disinterested directors nor the opinion of outside counsel can bar the Fund's shareholders from litigating the issue of liability to recover the cost of legal expenses. It would be absurd and illogical to deny the same shareholders the right to litigate the same issue

of liability against the same directors, where the question is not merely whether the defendants are to be indemnified for expenses but, rather, whether they are to be completely immunized from liability and from independent judicial scrutiny.

The implied rights of action which appellants seek to exercise exist because they are deemed necessary by the courts to effectuate and enforce congressional policy embodied in the Investment Company Act and Investment Advisers Act. Those rights must be made available, in a meaningful sense, not merely in a cosmetic sense, to those most vitally interested in effective enforcement of the legislation. Congress itself has mandated that there be no protection from liability for conduct such as is involved in the present case to those who manage investment companies. It is also clear that in such cases there should be adequate independent scrutiny. Consequently, a decision not to sue by a minority of a controlled mutual fund board cannot be allowed to prevent plaintiffs from going forward in this litigation, without doing violence to the letter and spirit of the applicable legislation and congressional policies.

POINT II

MUTUAL FUND DIRECTORS DO NOT HAVE THE POWER TO ABORT ONGOING JUDICIAL REVIEW OF CHARGES OF FRAUD, GROSS MISCONDUCT AND ABUSE OF TRUST AGAINST FELLOW FIDUCIARIES BECAUSE THEY WOULD THEREBY IMPERMISSIBLY SANCTION, IN SUBSTANCE IF NOT IN FORM, FRAUDULENT AND GROSSLY UNLAWFUL ACTS.

Mutual fund directors simply do not have the power to

sanction fraudulent and unlawful conduct by fellow fiduciaries, particularly where the victims of that conduct are the fund's shareholders, the intended beneficiaries of the federal statutes whose enforcement was aborted in the court below. Thus, in Arthur Lipper Corp. v. S.E.C., 547 F.2d 171, 179 (2d Cir. 1976) this Court recently stated:

"[I]t is not within the competence of a board of directors of an investment company to sanction the perpetration of a fraud by the manager."

This principle of non-ratification is uniquely applicable to mutual funds because their boards are, and traditionally have been, subject to pervasive control by their investment advisers. However, the principle is recognized even with respect to business corporations generally.

"It is settled law in Delaware that if the acts are ultra vires, illegal or fraudulent they may not be ratified." Toebelman v. Missouri-Kansas Pipe Line Co., 130 F.2d 1016, 1022 (3d Cir. 1942).

* * *

"[A]cts which are ultra vires, illegal or fraudulent are expressly excepted from the class of acts subject to ratification." Keenan v. Eshelman, 12 A.2d 904, 909 (Del. 1938).

The same rule applies in New York. See Continental Securities Co. v. Belmont, 206 N.Y. 7, 17-19 (1912).

In the present case, two fund shareholders sued in 1973 for fraud, gross misconduct and abuse of trust by insider fiduciaries. Two years later, five minority directors, selected by

defendants, purported to terminate this litigation without recourse on the ground that they had decided, as a matter of business judgment, that any further judicial review of defendants' conduct should cease.

While defendants strenuously argued that the merits of appellants' claims should not be inquired into judicially, it is nevertheless clear that the minority directors rested their purported business judgment, at least in part, on the premise that defendants' conduct in connection with the Penn Central fiasco had been proper and that appellants' claims were without merit.*

Under these circumstances, and particularly within the context of an abuse-prone industry which Congress has sought to subject to prophylactic regulation, the aborting of the present litigation, without judicial scrutiny of the merits, would amount to a sanctioning of defendants' conduct, in substance if not in form. Thus, the Supreme Court of Delaware had occasion to observe in Mayer v. Adams, 141 A.2d 458, 461 (Del. 1958):

"[A] decision not to press a claim for alleged fraud committed by the directors means, in effect, that the wrong cannot be remedied. It is conceded that the wrong cannot be ratified by the majority stockholders, but it is said that refusal to sue is a different thing from ratification. Strictly speaking, this is true, but the practical result is the same."

The court below rejected the principle that a decision

* One of the minority directors, Mrs. O'Connor, testified:
"The case was without merit and that was it" (985A).

not to sue under the circumstances of the present case was tantamount to ratification, stating that "the question of business judgment is separate from the question of ratification." The district court cited in this regard the case of S. Solomont & Sons Trust v. New England Theatres Operating Corp., 93 N.E. 2d 241, 247 (Mass. 1950) (151A). However, the Solomont case is a demand case* and, also, arose under the particularly stringent requirements for a demand on shareholders under Massachusetts law. The Solomont case has no applicability to the case at bar. Indeed, in Levitt v. Johnson, 334 F.2d 815 (1st Cir. 1964), cert. denied, 379 U.S. 961 (1965) the First Circuit discussed the Solomont case and refused to apply the law of that case to a Massachusetts business trust in a stockholders' derivative action arising under the Investment Company Act, precisely because the effect would have been to prevent the action from going forward and thereby frustrate enforcement of the Act.

The district court also stated that various cases establishing the business judgment rule in relation to derivative suits involved claims that were "arguably non-ratifiable," citing two antitrust cases, United Copper Securities Co. v. Amalgamated Copper Co., 244 U.S. 261 (1917) and Ash v. IBM, 353 F.2d 491 (3d Cir. 1965), cert. denied, 384 U.S. 927 (1966) (151A). Those cases, however, simply involved a routine business decision as to

* The present case is not a demand case and, as recognized by the district court, defendants have not disputed appellants' allegation that demand was excused as legally futile (147A).

whether to pursue a corporate antitrust claim against third-party outsiders. They did not involve any issue of sanctioning non-ratifiable conduct or condoning fraud or gross misconduct against a mutual fund or its stockholders by fiduciary insiders. See Levitt v. Johnson, supra at 820 n.5.

POINT III

SINCE IT IS CLEAR FROM THE INVESTMENT COMPANY ACT THAT CONGRESS DID NOT INTEND THE DETERMINATIONS OF DISINTERESTED DIRECTORS TO BE WITHOUT RECOURSE BY THE SHAREHOLDERS (IN FACT CONGRESS INTENDED THE CONTRARY), IT IS INCONSISTENT TO VEST SUCH DIRECTORS WITH THE POWER TO ABORT WITHOUT RECOURSE A VALIDLY COMMENCED SHAREHOLDERS' ACTION ALLEGING FRAUD, GROSS MISCONDUCT AND ABUSE OF TRUST.

In Tannenbaum v. Zeller, supra at 91,326-327 this Court recognized that the mutual fund industry is in many ways unique, that a mutual fund is a mere shell largely dominated and controlled by its investment adviser, whose primary interest is the maximization of its own profits. The Court also noted that there are important conflicts of interest between management and the shareholders of a mutual fund. See also Galfand v. Chestnutt, supra at 808-09, in which Chief Judge Kaufman observed:

"The relationship between investment advisers and mutual funds is fraught with potential conflicts of interest.... Compensation for [the adviser's] services is determined under an advisory contract, the terms of which are all too often dictated to unwary or negligent fund directors and fund shareholders by the investment adviser."

Because of the typical conflicts of interest between a fund's shareholders and its adviser Congress provided in the Investment Company Act that a certain percentage of a fund's board of directors should have no affiliation with the adviser. The unaffiliated, now disinterested, directors were intended by Congress to function as "watchdogs" for the benefit of a fund's shareholders in checking managerial abuses. Tannenbaum v. Zeller, supra at 91,327. However, the Act nowhere confers upon disinterested directors the unfettered power to cut off the rights of shareholders, as they have attempted to do in the present case. To the contrary, where special responsibilities are conferred on these directors, it is always subject to recourse by the shareholders.

Thus, Section 15(c) of the Act imposes on disinterested directors a duty to review and approve the contracts of the investment adviser and principal underwriter. However, approval of these contracts, in turn, is subject to the shareholders' right of judicial review under Section 36(b).

Section 16(b) of the Act requires that a majority of the disinterested directors nominate other disinterested directors to fill vacancies occurring upon an assignment of the advisory contract. However, such nominees are then subject to election by the shareholders.

Section 32(a) of the Act requires that a majority of the disinterested directors select a public accountant. Again, however,

the selection must then be submitted to the shareholders for their approval.

In addition, contrary to state business corporation practices, under Section 17 of the Act a disinterested quorum of directors is not empowered to authorize or ratify various insider transactions, regardless of disclosure, fairness or reasonableness. Instead, Section 17(b) provides that such a proposed insider transaction must be submitted in advance to the S.E.C., which may grant an exemption only if it finds the transaction to be fair, reasonable, without overreaching, and consistent with policies of the investment company and the Act itself. (Compare the present case, in which it is proposed that serious charges of fiduciary misconduct against insiders be dismissed without judicial scrutiny of the merits.) If disinterested directors are thus precluded by the Act from acting upon transactions in which insiders are personally interested, how can they be deemed to have the authority, consistent with the purposes of the Act, to absolve summarily the same persons from millions of dollars in personal liability, as they have attempted to do here? Clearly, they cannot.

One of the most important responsibilities assigned to disinterested directors under the Act is the approval of the investment adviser's and principal underwriter's contracts. This obviously is an area of substantial conflict of interest between the shareholders and the adviser, and again, the disinterested

directors are expressly precluded from acting dispositively for the shareholders. Notwithstanding the business judgment of the disinterested directors, shareholders are given an express right under Section 36(b) of the Act to challenge in court payments made pursuant to these contracts. Here again, it is clear that the Act not only does not confer final decision-making authority on the disinterested directors to the exclusion of the shareholders, but in areas where there is a substantial conflict of interest between the shareholders and the adviser, the Act specifically precludes it.

The congressional rationale for providing shareholder recourse to the courts under Section 36(b) is of compelling applicability to the present case. The Senate report recommending passage of the 1970 amendments to the Investment Company Act, including Section 36(b), found that disinterested directors of mutual funds had no real independence from the adviser and hence lacked any real bargaining power in negotiating fees. Senate Report No. 91-184, 91st Cong., 2d Sess., 3 U.S. Code Cong. & Admin. News 4897, 4901 (1970). In view of this absence of independence and bargaining power by disinterested directors, Congress recognized that they could not be relied upon to protect the shareholders' interests and under Section 36(b) gave shareholders the express right to sue derivatively for excessive fees paid to the adviser and principal underwriter.

In Boyko v. The Reserve Fund, Inc., 68 F.R.D. 692, 696 (S.D.N.Y. 1975) the court stated:

"It thus appears that in enacting Section 36(b) Congress assumed that the directors of the investment company would be antagonistic toward, and unlikely to prosecute, an action against the Fund's advisors for breach of fiduciary duty with respect to the receipt of compensation. In the instant case, the Fund admits its opposition to the lawsuit and argues that a decision of its board not to prosecute the action would be conclusive, thus precluding a shareholder from asserting the claims derivatively. While this rule might be appropriate in other kinds of derivative actions, its application in this context would clearly thwart the purpose of Congress in enacting Section 36(b) since a majority of the board of an investment company is rarely composed of 'interested persons' and tangible indications of bias on the part of the unaffiliated majority are rarely present. As stated in the legislative history, control of a mutual fund by its advisor is the result of intangible factors arising out of the unique structure of the industry."

If Congress was correct in assuming that disinterested directors would be loath to prosecute an action against a fund's adviser with respect to excessive management fees, is it any more likely they would be favorably disposed to a lawsuit against the investment adviser for fraud and gross abuse of trust, involving millions of dollars in liability? Obviously not. It is also clear that the disinterested directors of a fund, particularly a minority, should no more be empowered to terminate this litigation without recourse than they are empowered to exercise any other power without recourse under the enabling legislation to which they owe their very existence.

Disinterested directors were intended to serve the shareholders as protectors of their interests. Nevertheless,

this Court has taken cognizance of the fact that reliance on unaffiliated directors in the past has proven inadequate to this end. Tannenbaum v. Zeller, supra at 91,327; Galfand v. Chestnutt, supra at 808. In the present case, in the name of protection they are acting to frustrate, to the extent of millions of dollars, the entitlement of those whose interests they are supposed to champion. Congress has mandated that mutual funds be operated and managed for the benefit of the shareholders who own them, not for the benefit of those who manage them. Consistent with that congressional policy, appellants must be given the opportunity to prosecute their claims of managerial fraud and abuse.

POINT IV

AFFIRMANCE OF THE DECISION BELOW WOULD SANCTION A DEVICE FOR FRUSTRATING PRIVATE ENFORCEMENT OF THE FEDERAL SECURITIES LAWS.

The courts have developed a sound and well-established principle whereby a plaintiff suing derivatively need make no demand on a board of directors, if a majority of its members are wrongdoers in the action. E.g., Liboff v. Wolfson, 437 F.2d 121, 122 (5th Cir. 1971). The underlying rationale of this principle is that "business judgment" does not apply in such a situation and that it would not promote the ends of justice to place the prosecution of litigation under the control, direct or indirect, of those interested in its defeat. Defendants in the present case, comprising a majority of a disqualified board, would turn this principle of futility of demand inside out. A derivative

plaintiff having successfully pleaded futility of demand by virtue of a disqualified majority (and hence, the inapplicability of "business judgment") may enter the courthouse door one day only to find himself turned out the next by a minority of the same disqualified board.

If such a procedure were sanctioned, it would provide a device by which corporate insiders charged with wrongdoing could opt for their own absolution from serious charges of fiduciary misconduct. If an available quorum does not exist, the controlling majority may be able to establish one, particularly in controlled corporations such as investment companies, which are essentially shells dominated by their investment advisers. Defendant directors can be rotated out of office until a quorum perceived as friendly is available to exercise business judgment:

"The court should not cajole itself into believing that the members of a Board of Directors elected by the dominant and accused majority stockholder, after accusations of wrongdoing have been made, were selected for membership on the Board to protect the interests of the minority stockholders and to assure a vigorous prosecution of effective litigation against the offending majority." Cohen v. Industrial Finance Corp., 44 F. Supp. 491, 494 (S.D.N.Y. 1942).*

* In the present case, all of the minority directors were selected by a defendant-dominated committee and board after the investment losses in question had been sustained, after the defendant-controlled board had voted to sue Goldman, Sachs and after the same board had voted to postpone until after the Goldman, Sachs action the determination of the question of what action should be taken against Anchor and the other defendants (See Point VIII, infra).

It is unrealistic to sanction such a procedure in principle and then attempt to ferret out abuses on a case by case basis. Particularly in the case of mutual funds:

"[T]angible indications of bias on the part of the unaffiliated majority are rarely present. As stated in the legislative history, control of a mutual fund by its adviser is the result of intangible factors arising out of the unique structure of the industry." Boyko v. The Reserve Fund, Inc., supra at 696.

This fact of life in the mutual fund industry has been put as follows by one commentator:

"[O]bviously you know and I know that if you are choosing an unaffiliated director or an independent director you are not going to choose anybody who is going to be too hard on you. You are going to tend to pick a friend of yours. . . ." Conference on Mutual Funds, 115 U. Pa. L. Rev. 662, 739 (1967) (remarks of Abraham L. Pomerantz).

Another commentator has stated:

"Thus, through either informal suggestions or the veto often given the adviser's representatives on the committee, the selection of independent directors effectively remains in the adviser's hands." Nutt, "A Study of Mutual Fund Independent Directors," 120 U. Pa. L. Rev. 179, 216 (1971-72).

In the same vein, the Wharton Report concluded:

"It should be noted that a nonaffiliated person may and frequently does include a relative, a close personal friend, or a business associate falling outside of the scope of the limited definition of 'affiliated person' in section 2(a)(3) of the act of 1940. It seems likely that where unaffiliated or 'independent' directors may be selected by a controlling

management group, the latter will be able if they desire to arrange for a friendly board that is independent in only a limited sense. Moreover, there appears to be no feasible way of defining 'affiliation' so as to overcome this difficulty to any great extent, while the power to choose directors is still in the hands of the management." Wharton School of Finance & Commerce, "A Study of Mutual Funds", H.R. Rep. No. 2274, 87th Cong., 2d Sess. 465-66 (1962) (foot-note omitted).

Finally, the Supreme Court, foreshadowing the above quoted comment of the district court in Boyko, observed more than a decade ago:

"The objection...rests...not in what was done in the particular case.... The court will not inquire what was done. If that should be improper it probably would be hidden and would not appear." S.E.C. v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 197 n.50 (1963).

The additional portent of the decision below is that the business judgment rule, if it were available after the concededly valid commencement of a derivative action to bar continuation of the litigation, presumably could be employed at any stage in the proceedings. At whatever point it were exercised, the litigation would come to a halt. If a minority of a disqualified board has business judgment to abort an ongoing litigation, can such judgment be invoked in the midst of trial, after verdict or judgment on the merits, on appeal? To recognize such ongoing business judgment beyond the threshold of litigation, i.e., the filing of the complaint, would be to accord to defendants an

escape hatch whose attractiveness would increase commensurately with the seriousness and substantiality of the threatened liability.

We submit that F.R.C.P. Rule 23.1 embodies the outer limits of the business judgment rule as it relates to the prosecution of derivative actions in the federal courts. The Rule establishes an initial pleading requirement which must be met to gain entry to the courthouse. Once entry has been gained, as in the present case where no issue has ever been raised as to the futility of demand, plaintiffs are entitled to proceed free of any revolving door theory which would subject them to the ongoing risk of dismissal at such time as a minority of a disqualified board might decide to abort the litigation for alleged business reasons.

POINT V

THE DECISION BELOW IS PREDICATED ON "DEMAND"
CASES WHICH HAVE NO APPLICABILITY TO THE
PRESENT CASE.

The district court acknowledged that the technique of utilizing a "disinterested quorum" after the commencement of a derivative action to determine whether the action should proceed is "unique" (147A). Subsequent to the present case, a similar procedure was followed in Gall v. Exxon, 418 F. Supp. 508, 515-16 (S.D.N.Y. 1975), which relied on the decision below as authority. Both the present case and the Exxon case have been

criticized as unwarranted extensions of the business judgment rule. See Bernstein, "An Extension of Business-Judgment 'Cloak,'" New York Law Journal, March 28, 1977, p. 1, col. 1.

Every precedent cited by defendants and relied on by the district court was a "demand" case, i.e., a case involving the issue of whether a plaintiff stockholder in a derivative action was required, prior to filing a complaint or an amended complaint, to make a demand on the corporation's board. E.g., Hawes v. Oakland, 104 U.S. 450 (1881); In re Kauffman Mutual Fund Actions, 479 F.2d 257 (1st Cir.), cert. denied, 384 U.S. 927 (1966); Brody v. Chemical Bank, 517 F.2d 932 (2d Cir. 1975). There is no authority for the untenable proposition that a plaintiff who is legally excused from making a demand as of the time of the filing of his pleading or amended pleading is nevertheless subject to having his action dismissed simply because thereafter there may come into existence a quorum of disinterested directors who believe the action should not proceed. See Nelson v. Pacific Southwest Airlines, 399 F. Supp. 1025, 1030-31 (N. D. Cal. 1975).

The present case, as previously noted, is not a demand case. Consequently, none of the demand cases relied on by the court below is relevant. As the district court recognized, defendants have never even contested the fact that as of the time plaintiffs' complaint was filed in 1973 a demand on the Fund's board was legally excused as futile. This is because most, if not all, of the Fund's directors, as of that time,

were named as defendants. See Liboff v. Wolfson, supra; Levitt v. Johnson, supra at 817; Cathedral Estates, Inc. v. Taft Realty Corp., 228 F.2d 85, 88 (2d Cir. 1955); Jannes v. Microwave Communications, Inc., 57 F.R.D. 18, 21 (N.D. Ill. 1972); Barr v. Wackman, 36 N.Y. 2d 371, 379 (1975). Thus, even if the present case involved the issue of demand, appellants would clearly be entitled to prevail on that issue.

Even as of January 1975, when the so-called "disinterested quorum" adopted its resolution advocating the termination of this litigation, a majority of the Fund's board (six of eleven) still consisted of defendants named in this action or their representatives. Of the eleven directors then in office, five were defendants charged with wrongdoing and a sixth was the president and a director of Anchor (See Point VIII, infra). Thus, even if appellants had filed their complaint in January 1975, no demand on the Fund's board would have been required. See the authorities cited above and also Boyko v. The Reserve Fund Inc., supra at 696, in which the court held that the presence of a single insider director on a mutual fund's board obviates the necessity for a demand. Cf., Brody v. Chemical Bank, supra. In short, the holding of the district court, apart from being affirmatively unsound, is also completely without precedential support. This absence of supportive authority is an added reason for reversal of the orders and judgment appealed from.

* * *

For the reasons discussed in Points I through V, this Court should reject categorically, as unsound and undesirable, the proposition that the minority directors could, under any circumstances, require the district court, on the basis of their "business judgment," to terminate this litigation. However, even if this Court were to accept a contrary premise for the sake of argument, in no event should the minority directors' purported exercise of business judgment be sustained without according to appellants an opportunity to conduct discovery on the merits and without evaluating the merits themselves to ensure fairness to the Fund's shareholders. In addition, apart from any other consideration, it is unrealistic to conclude, under the circumstances of this case, that the minority directors acted on the basis of full and adequate disclosure or that they were, with respect to this litigation, truly independent of the controlling defendants.

* * *

POINT VI

APPELLANTS' SUBSTANTIVE CLAIMS ARE CLEARLY MERITORIOUS AND THEIR ABANDONMENT WOULD RESULT IN A PATENT INJUSTICE TO THE FUND'S SHAREHOLDERS.

The Court Should Consider The Merits Of Appellants' Claims In Assessing The Appropriateness Of The Result In The Court Below.

In support of their motion for dismissal defendants repeatedly referred to the alleged lack of merit of appellants' claims. Undoubtedly, this was because they felt a need to render

more palatable the implication of their legal position, i.e., that on the basis of the "business judgment" of a minority of the board of a federally regulated mutual fund, a federal court should dismiss, without scrutiny, claims of gross misconduct and gross abuse of trust involving many millions of dollars of loss to public shareholders and falling squarely within the ambit of prophylactic congressional legislation.

Defendants placed themselves in the untenable position of asking the district court to assume that appellants' claims have no substance, on the basis of the out-of-court opinions of special counsel submitted as part of defendants' moving papers, without discovery on the merits and without presenting a single piece of evidence. On this basis, defendants sought to terminate the litigation, the very object of which is to test the merits of the claims they assert to be without substance.

Under these circumstances, there are at least three reasons why this Court should consider the merits of appellants' claims in assessing the appropriateness of the result reached by the district court.

First, judicial scrutiny of an investment adviser's conduct is essential to ensure fairness. Thus, in Galfand v. Chestnutt, supra, it was held that even had the investment adviser made full disclosure to the fund's nonaffiliated directors concerning the revision of its advisory contract, the business

judgment of the nonaffiliated directors would not have been controlling and would still have required judicial review of the merits of the underlying transaction. This Court stated:

"[E]ven where a fiduciary has made full disclosure, it is the duty of a federal court to subject the transaction to rigorous scrutiny for fairness" (545 F.2d at 811-12).

A version of this principle of judicial scrutiny, albeit in less direct terms, was forecast by Judge Fuld in his second report to the minority directors, in which he stated:

"In short, it is my view that, at a minimum, the court would review the reasons for seeking dismissal and might consider, at least to some degree, the underlying merits of the derivative action" (101A).*

Second, judicial review of the merits is essential to effect meaningful compliance with the applicable statutes. Section 1(b)(2) of the Investment Company Act, as previously indicated, states as a declaration of policy that the national public interest and the interest of investors are adversely affected when investment companies are operated and managed in the interests of directors and investment advisers rather than in the interests of the shareholders. Section 1(b) also mandates that the provisions of the Act be interpreted so as to mitigate abuses which adversely affect the national interest and the interest of investors. At a

* In his first report, Judge Fuld was more direct: "If...the Fund were actively to seek dismissal of the suit, current court procedures would appear to require a hearing substantially on its merits" (94A). It is also noteworthy that each of the minority directors themselves stressed the importance of the merits (643A, 773A, 885A-886A, 985A, 1026A).

minimum, judicial consideration of the merits of appellants' claims is a prerequisite to ascertain whose interests are being served by the minority directors' determination to seek dismissal of the present action.

Third, since a settlement proposed by disinterested directors (even a nominal one) would require, under F.R.C.P. Rule 23.1, discovery on the merits and review of the merits by the district court, notwithstanding their business judgment, surely an outright dismissal, with no attendant consideration to the Fund, proposed by the same directors, must require at least the same safeguards to ensure fairness. Birnbaum v. Birrell, 17 F.R.D. 409, 411 (S.D.N.Y. 1955); Berger v. Dyson, 111 F. Supp. 533 (D.R.I. 1953); Denicke v. Anglo California Nat. Bank, 45 F. Supp. 524, 529 (N.D. Cal. 1942), aff'd, 141 F.2d 285 (9th Cir. 1944), cert. denied, 323 U.S. 739 (1944); 3B Moore, Federal Practice ¶23.1.24[2], p. 23.1-138.*

The Merits Of Appellants' Claims Are Compelling.

Judge Fuld's report confirms that Anchor, which was paid approximately \$4 million annually for its advisory services, made no independent investigation prior or subsequent to recommending the Fund's purchase of \$20 million of Penn Central commercial paper. Anchor never investigated either Penn Central's overall

* The authorities cited further establish that notwithstanding the fact that a proposed settlement is sanctioned by a board consisting of a majority of disinterested and independent directors, the same requirements of discovery and judicial review of the merits apply.

financial condition or the safety of its short-term securities, notwithstanding that the Fund's \$20 million purchase constituted the largest single investment made by it during the period in question. Judge Fuld's report states that Anchor:

"did not undertake, or . . . perform, an independent analysis of the financial condition of . . . Penn Central . . . or any continuing review during the period in which the purchased paper was held by the Fund" (63A; see also 74A).

With respect to the initial purchases, which were made within a ten-day period commencing November 28, 1969, Anchor relied on the recommendation of Goldman, Sachs, which it believed had conducted its own investment analysis of Penn Central's paper (61A, 62A). Anchor seems to have been oblivious to the fact that Goldman, Sachs was selling for its own account at arms-length and was not acting on the Fund's behalf and that it was Anchor, not Goldman, Sachs, that was paid to advise the Fund.

The Fund's subsequent retention of the paper, right up to Penn Central's petition in bankruptcy on June 21, 1970, apparently was based on the fact that Goldman, Sachs continued to sell substantial amounts of Penn Central paper to other investors throughout the first quarter of 1970. On nothing more than this, Anchor continued to assume that Goldman, Sachs was conducting an ongoing analysis of Penn Central and that Penn Central's paper was safe (82A-83A).

Anchor obviously had no right either to make these assumptions or to abdicate its independent advisory role by relying on any express or implied representation by Goldman,

Sachs as to the creditworthiness of the paper. Goldman, Sachs was not an agent for the Fund, or even a disinterested professional, but rather a commercial dealer acting solely for itself and seeking to reduce its own inventory of commercial paper, the desirability of which was rapidly diminishing. Goldman, Sachs had no fiduciary obligation to the Fund. On the other hand, Anchor, which receives several million dollars annually from the Fund for its investment advisory services, was the Fund's fiduciary and could not discharge its obligations by abdicating its responsibility to Goldman, Sachs (134A).*

Judge Fuld reported to the minority directors that there was an absence of any authority with respect to the question of whether Anchor had an obligation to conduct an independent investigation in connection with the Fund's purchases (77A, 91A). However, there exists substantial authority establishing that an independent investigation was required and this authority apparently was not brought to Judge Fuld's attention.

In Matter of Winfield & Co., Inc., CCH Fed.Sec.L.Rep. [1971-72 Transfer Binder] ¶78,530,p. 81,147 (S.E.C. 1972) the Securities and Exchange Commission approved sanctions against an investment adviser and an affiliated fund director for causing the fund to

* At his deposition Mr. Kendall, chairman of the minority directors, expressly conceded that a mutual fund adviser, such as Anchor, is obligated to perform research as part of its investment advisory services (506A-511A, 645A-646A).

purchase certain restricted securities without making a reasonable investigation.

The Commission stated:

"[I]n causing the Fund to purchase restricted securities, Adviser and Meid failed to make reasonable investigations to obtain pertinent information concerning such securities. The record shows that in many cases Meid relied on unsubstantiated representations of other persons, described by him as 'research sources,' and that such persons frequently had a substantial economic interest in the offering or the issuer of such securities. Adviser and Meid had an obligation to make a reasonable investigation before causing the Fund to purchase any securities" (Emphasis added).

The Commission specifically stated that the failure of an investment adviser to conduct a reasonable investigation constituted a violation of Section 36 of the Investment Company Act, one of precise sections upon which appellants' claims are predicated:

"Cf. Securities Act Release No. 4445 (February 2, 1962) and cases cited there, with respect to the duty of a broker-dealer to make a reasonable investigation before recommending a security. The obligation of a broker-dealer in this area arises under the antifraud provisions of the federal securities laws. Those provisions are, of course, applicable as well to an investment adviser of a registered investment company. Moreover, when registered investment companies are involved, the obligation also is imposed by Sections 15 and 36 of the Investment Company Act. Cf. Brown v. Bullock, 294 F.2d 415 (C.A. 2, 1961) (Id. at 81,147n.14) (Emphasis added).

In Securities Act Release No. 4445, CCH Fed.Sec.L.Rep. [1961-64 Transfer Binder] ¶76,820, p. 81,068, referred to in the previous quotation, the Commission made the following statement

regarding investment recommendations by broker-dealers:

"The Commission has . . . repeatedly held that it is a violation of the anti-fraud provisions for a broker-dealer to recommend a security unless there is an adequate and reasonable basis for the recommendations and, further, that such recommendations should not be made without disclosure of facts known or reasonably ascertainable, bearing upon the justification for the recommendation. As indicated, the making of recommendations for the purchase of a security implies that the dealer has a reasonable basis for such recommendations which, in turn, requires that, as a prerequisite, he shall have made a reasonable investigation" (Footnotes omitted) (Emphasis added).

In Hanly v. S.E.C., 415 F.2d 589 (2d Cir. 1969), recently reaffirmed in Franklin Savings Bank v. Levy, CCH Fed. Sec.L.Rep. ¶95,902 (2d Cir. 1977), this Court held, consonant with the S.E.C.'s position, that a broker-dealer has a duty to conduct an adequate investigation before recommending the purchase of a security and that failure to do so constitutes a violation of the federal securities laws:

"Brokers and salesmen are 'under a duty to investigate, and their violation of that duty brings them within the term "willful" in the Exchange Act. Thus, a salesman cannot deliberately ignore that which he has a duty to know and recklessly state facts about matters of which he is ignorant. He must analyze sales literature and must not blindly accept recommendations made therein'" (415 F.2d at 595-96) (footnotes omitted).

* * *

"A salesman may not rely blindly upon the issuer for information concerning a company, although the degree of independent investigation which must be made by a securities dealer will vary in each case" (Id. at 597).

If securities brokers and salesmen must conduct an independent investigation and analysis prior to recommending a purchase of securities, and if by such recommendation they impliedly represent that they have done so, certainly Anchor, a highly paid, sophisticated investment adviser can do no less without violating its fiduciary obligations. Nevertheless, Anchor blindly accepted Goldman, Sachs' self-serving recommendations regarding the Penn Central paper, in gross violation of its duty to conduct its own investigation and review.

Judge Fuld speculated on the basis of the facts available to him that even had an independent investigation been conducted by Anchor, the principal information concerning Penn Central's adverse financial condition was not publicly available until April 23, 1970, by which time it was unlikely that the paper held by the Fund could have been resold (84A-85A).^{*} This conclusion is contradicted by defendant Haire himself who stated at the December 18, 1974 board meeting of the Fund that Goldman,

^{*} As we have previously noted, Judge Fuld qualified his report throughout, acknowledging that it was "impossible for one to predict what...a trier of fact will find, particularly in complex circumstances" (84A).

Sachs was repurchasing Penn Central paper as late as May 1, 1970 (109A).

Anchor's liability does not necessarily rest on what an adequate investigation might have revealed. See Fogel v. Chestnutt, supra at 750.* However, even if that were the proper standard, there was ample information, readily available to Anchor, as to Penn Central's poor financial condition, both prior to the Fund's initial purchase of the paper on November 28, 1969 and throughout the period of its retention. Anchor's purchase recommendation to the Fund, as late as November 1969, in the face of this readily available information, amounts to reckless violation of its fiduciary obligations as an adviser. Equally reckless was Anchor's allowing the Fund to retain the paper well into 1970.

Various courts, including this one, have addressed the relevant factual points and found the following:

"First quarter [1969] results for the parent railroad company showed a net loss of \$12.8 million, as compared with a profit of \$1.0 million for the similar

* In Fogel, an investment adviser was found to have violated Section 36 of the Investment Company Act by failing to make adequate disclosure to the disinterested directors concerning the possibility of recapturing brokerage fees. The Court said it was no defense that a decision not to recapture, after adequate disclosure, would have been a reasonable business judgment. The wrong was in the inadequate disclosure itself. Similarly, here, the wrong was committed by virtue of an uninformed recommendation, irrespective of what an actual investigation might have revealed.

period of the previous year." University Hill Foundation v. Goldman, Sachs & Co., CCH Fed.Sec.L.Rep. ¶95,749 at 90,641 n.6 (S.D.N.Y. 1976) (Emphasis added).

* * *

"The parent railroad company showed a net loss of \$8.2 million, compared with 1968 second quarter earnings of \$2.0 million" (Ibid).

* * *

"On October 20th [1969], Penn Central's third quarter earnings were announced, and they reflected a continued deterioration. For the first time the Company reported a consolidated loss, which was \$8.9 million (as compared to earnings of \$15.2 million for the third-quarter of 1968), and the parent railroad lost \$19.2 million (compared to a \$3.8 million loss for the same period in the previous year). Consolidated earnings for the first nine months were \$17.6 million down from \$52.2 million, and the railroad showed a loss for the year so far of \$40.2 million, against a 1968 nine month loss of only \$747,000. These figures were widely reported in the financial press" (Id. at 90,642) (Emphasis added).

* * *

"In November [1969] the papers carried reports of the testimony of Penn Central's counsel before agency hearings in Washington to the effect that the merged railroad was having serious difficulties, as well as reports that the Company had eliminated its fourth quarter dividend" (Id. at 90,643n.10).

* * *

"On February 4, 1970 Penn Central's financial statements for both the year 1969 and its last quarter were publicly announced. The loss for the year was \$56.3 million, ten times greater than that of the previous year. In the fourth quarter, the company had lost \$13.2 million." Franklin Savings Bank of New York v. Levy, supra at 91,353.

* * *

"Enough objective data was known concerning Penn Central in early 1970 to lead a reasonable observer to conclude that the commercial paper was not prime, and indeed the issuer became insolvent very shortly thereafter."
Welch Foods Inc. v. Goldman, Sachs & Co., 398 F. Supp. 1393, 1398 (S.D.N.Y. 1974).

These findings are confirmed by the S.E.C.'s investigation of the Penn Central collapse (S.E.C. Staff Report, "The Financial Collapse of the Penn Central Company," H.R. 12128, August 1972, pp. 11-14, 279,282). In addition, appellants' complaint in the present case refers to numerous other danger signals published during the critical period, which should have caused Anchor to exercise caution (11A-13A, 16A-17A).*

Without the benefit of the above reported findings, however, Judge Fuld assumed that the principal adverse information concerning Penn Central did not become available until April 23, 1970 when its first quarter 1970 losses were reported in the Wall Street Journal (84A-85A).

Penn Central's parent company's consolidated losses for the first quarter of 1970 totalled \$17.2 million, as compared with a net income of \$4.6 million for the same period the previous year, and the losses of Penn Central itself for the first quarter

* Many of these danger signals are the same ones which the Fund relied upon in its complaint against Goldman, Sachs. Counsel who signed the complaint in the Goldman, Sachs action represents Anchor in this one (see Document 10 of Index to Record, affidavit of Leonard Joseph, Exh. B).

of 1970 were \$62.7 million (See S.E.C. Staff Report, supra at 286). In fact, as discussed above, much of the relevant data had become publicly extant considerably earlier. Oblivious even to this information, Anchor made no attempt to extricate the Fund until an article appeared in the May 18, 1970 issue of Barron's expressing doubt about the safety of commercial paper generally. That article did not mention Penn Central by name, but raised sufficient concern about the safety of commercial paper generally to cause Anchor finally to seek to reduce the Fund's Penn Central holdings by one-half. By this late date Anchor's efforts to have Goldman, Sachs or Penn Central repurchase the paper were futile, and several weeks later, on June 21, 1970, Penn Central filed its petition for reorganization (63A-64A). It is difficult to imagine a more blatant unawareness of an impending disaster by a well-paid, well-staffed, sophisticated adviser than that exhibited by Anchor.

Anchor not only missed all the readily available public information concerning Penn Central's financial debacle but it also violated its own guidelines specifically relating to purchases of commercial dealer paper. Until the Fall of 1969 the Fund had purchased commercial paper directly only from a group of eight approved issuers. It had never made such purchases from dealers. In addition, in no event would the Fund make a purchase unless it obtained a binding agreement from the issuer to repurchase the paper from the Fund upon demand (58A-59A).

When Anchor began purchasing commercial paper directly from dealers, these purchases, as a matter of internal policy, were made expressly conditional on (1) the dealer's agreeing to repurchase the paper from the Fund upon demand and (2) the Fund's holding no more than 10% of the outstanding commercial paper of any single issuer (60A). Judge Fuld's report establishes without question that neither requirement was met. Thus, Goldman, Sachs was not required as a condition of its sale to the Fund to agree to repurchase the Penn Central paper upon demand (96A-97A). Had this requirement been adhered to, the Fund could have demanded that Goldman, Sachs repurchase the paper at any time, thereby eliminating any loss whatsoever. Furthermore, as a result of its failure to make an ongoing review, Anchor allowed the Fund's holdings to exceed the 10% safety limit (92A). Once again, adherence to this requirement alone would have reduced the Fund's losses by well over 50% (20A).

The facts thus far disclosed in the record reveal nothing less than a gross, bordering on willful, abdication by Anchor of its investment responsibilities. With respect to the defendant Fund directors, they too were grossly negligent in failing to oversee the Fund's basic investment policies or to supervise either the transactions in question or Anchor's performance with respect to those transactions. Judge Fuld's report establishes beyond doubt that the Fund's directors were, for reasons not explained, woefully ignorant, both before and after the Penn Central purchase, of the fact that Anchor had

instituted a fundamental change in procedure and had begun purchasing dealer paper. They also were unaware that Anchor was making no independent investigation or review of the companies whose paper was being purchased (90A). Further, specific purchases of short-term investments were not being identified in monthly reports to the board, but were lumped and simply identified generically as short-term investments (110A). Thus, the Fund directors did not even know that dealer paper was being purchased, did not know what specific purchases were being made and did not know what procedures Anchor was using in connection with the purchases. The directors apparently did nothing to inform themselves as to any of these matters.

At his deposition Mr. Laun, a member of the quorum, acknowledged the obligation of the Fund's directors to review the investment decisions made at the suggestion of the Fund's adviser and testified that he himself has, during his tenure, attempted to adhere to that obligation (1069A-1070A). However, as to the directors named as defendants in the present action, he testified:

"Q Did you make any attempt prior to proposing that the lawsuit be dropped against all of these directors, that are named as defendants in the Lasker action, did you make any attempt to find out whether they had discharged what you considered to be an obligation to review investments as to the Penn Central matter?

* * *

Q Did you make any such inquiry?

A I made no inquiry.

Q Did anybody else to your knowledge?

A No" (1071A).

That the Fund directors grossly deviated from their directorial duties is further indicated by a Fund prospectus, which states that Fund directors have an obligation to "determine the basic investment policies of the Fund" and to see that "all portfolio transactions will be . . . reported to the Board of Directors of the Fund for review and ratification" (134A). None of these obligations were complied with in connection with the Penn Central purchases.

At the time of defendants' wrongful acts the standard of liability under Section 36 of the Investment Company Act was "gross misconduct or gross abuse of trust."* In Brown v. Bullock, supra, the court interpreted this standard as follows:

"Section 36 imposes upon investment company directors, officers, investment advisers and principal underwriters fiduciary obligations appropriate to their respective trustee and managerial responsibilities in the handling of other people's money" (194 F. Supp. at 238 n.1).

On the basis of the present state of the record, even without the benefit of discovery, there is ample evidence that Anchor and the defendant Fund directors violated the fiduciary obligations imposed by Section 36.

* By virtue of the 1970 amendments to the Act a standard of "breach of duty involving personal misconduct" was incorporated into a new Section 36(a) in lieu of the prior language. The present case is governed by the language quoted in the text.

Appellants have also alleged that Anchor's course of conduct operated as a fraud within the meaning of Section 206 of the Investment Advisers Act. Judge Fuld seems to have been of the view that scienter under that section requires a specific intent to defraud, which he deemed absent in this case (72A-74A). However, in S.E.C. v. Capital Gains Research Inc., supra, the Supreme Court stated with respect to Section 206 that even if Congress had intended to embrace the requirements of common law fraud in enacting that section, a distinction must be made between ordinary actions for fraud and actions like the present one, involving a breach of duty by fiduciaries. Given the fact that an investment adviser is a fiduciary, the Supreme Court concluded that Congress had intended Section 206 to embrace the equitable concept of fraud, which, in cases involving fiduciaries, is to be applied remedially, not technically as in arms-length damage suits (375 U.S. at 193-95). The Court concluded that Section 206 required no actual intent to injure:

"Nor is it necessary in a suit against a fiduciary, which Congress recognized the investment adviser to be, to establish all the elements required in a suit against a party to an arm's-length transaction" (Id. at 194).

* * *

"'Fraud, indeed, in the sense of a court of equity properly includes all acts, omissions and concealments which involve a breach of legal or equitable duty, trust, or confidence, justly reposed, and are injurious to another. . . .'" (Ibid.) (Footnote omitted).

* * *

"We cannot assume that Congress, in enacting legislation to prevent fraudulent practices by investment advisers, was unaware of these developments in the common law of fraud. Thus, even if we were to agree with the courts below that Congress had intended, in effect, to codify the common law of fraud in the Investment Advisers Act of 1940, it would be logical to conclude that Congress codified the common law 'remedially' as the courts had adapted it to the prevention of fraudulent securities transactions by fiduciaries, not 'technically' as it has traditionally been applied in damage suits between parties to arm's length transactions involving land and ordinary chattels" (Id. at 195).

In the same vein, in Santa Fe v. Green, CCH Fed.Sec.L. Rep. ¶95,914 at 91,451n.11 (1977) the Supreme Court distinguished Section 206 from Section 10(b) and Rule 10b-5 of the Securities Exchange Act of 1934 with the observation that:

"Although Capital Gains involved a federal securities statute, the Court's references to fraud in the 'equitable' sense of the term were premised on its recognition that Congress intended the Investment Advisers Act to establish federal fiduciary standards for investment advisers."

Recently, this Court itself, in Abrahamson v. Fleschner, supra at 91,248n.26, in a private damage action arising under Section 206, stated:

"Scienter does not require a showing of intent to cause a loss to a plaintiff" [citing the Capital Gains case].

It was thus not legally necessary that Anchor have had any specific intent to injure the shareholders. All that was required was that it intended its acts. See S.E.C. v.

Capital Gains Research Bureau, Inc., supra at 200-01; Arthur Lipper Corporation v. Securities and Exchange Commission, supra at 180-01. Anchor's failure to conduct any independent investigation or review regarding the Penn Central purchases was a gross, if not willful, abdication of its fiduciary duties to the Fund and its shareholders and clearly constitutes fraud within the meaning of Section 206.

Based on the acts described, both Anchor and the defendant Fund directors are also liable under Delaware law for negligence (see Graham v. Allis Chalmers Mfg. Co., 188 A.2d 125, 130 (Del. 1963); Fletcher, Cyclopedia Corporations §1019 at 573 (Perm. ed. 1965)), as well as for related claims set forth in appellants' complaint.

For the reasons stated at the beginning of this Point, the congressional policies embodied in the Investment Company Act and Investment Advisers Act, as well as fairness to the Fund's shareholders, require at a minimum a judicial assessment of the merits of appellants' claims to determine whether their dismissal truly serves the interests of the Fund's shareholders or those of its managers.

POINT VII

THE MINORITY DIRECTORS DID NOT HAVE THE BENEFIT OF FULL AND ADEQUATE DISCLOSURE SINCE (1) THEY WERE MATERIALLY MISLED BY DEFENDANT HAIRE AND (2) THEY WERE ADVISED BY THE FUND'S LITIGATION COUNSEL WHO WAS NOT DISINTERESTED WITHIN THE APPLICABLE STATUTORY DEFINITION.

At the Fund's December 18, 1974 board meeting defendant

Haire spoke to the minority directors in detail of the alleged adverse impact to Anchor if the present case were allowed to go forward, referring to the "substantial distraction to Anchor," the effect on its ability "to attract and retain...highly qualified personnel" and its financial ability to satisfy a judgment in the full amount of the claim (114A). These very reasons were adopted by the minority directors, were relied on in reaching their decision to seek dismissal of this case and were recited in the affidavit of Mr. Kendall presented to the district court (47A).

On the basis of Haire's statements the minority directors concluded that the consequent "adversary relationship" and "serious distraction of Anchor's personnel from their efforts on behalf of the shareholders...would leave us no practical alternative but to remove Anchor as investment adviser" (48A). Thus, the minority directors were confronted with the Hobson's choice of terminating this litigation or permitting the litigation to proceed at the cost of terminating the Fund's advisory contract, a profoundly disruptive if not impossible course:

"Moreover, even if some of the unaffiliated directors were so inclined, they might not have the power to obtain another investment adviser for the fund. In some cases, the unaffiliated directors are only a minority; in many others they constitute only a bare majority of the board of directors and would need the support of all the unaffiliated directors for this drastic step. Even with such support it is unlikely that the action of the unaffiliated directors would be uncontested, since the interest of the existing

advisory organization in continuing its relationship to the fund might induce the adviser to devote considerable resources to a proxy contest to retain control of that relationship.

"The possibility of disrupting the fund's operations, the prospect of a bitter and expensive proxy contest, and the risk and uncertainty involved in replacing the entire fund management organization with a new and untested one, make termination of the existing advisory relationship a wholly unrealistic alternative in negotiations over advisory fees. Without such an alternative, advisory fees negotiated between advisers and the unaffiliated directors lack the essential element of arm's-length transactions and provide inadequate assurance that the fees bear a reasonable relationship to the price at which similar services could be obtained in a genuinely competitive market." Securities and Exchange Commission, "Public Policy Implications of Investment Company Growth", H.R. Rep. No. 2337, 89th Cong., 2d Sess. 131 (1966).

Faced with the alternative of terminating either Anchor or the litigation, there could be no question of the minority directors' choice. Yet, when questioned at his deposition subsequent to the filing of defendants' motion to dismiss, Haire gave testimony diametrically opposed to his December 18, 1974 disclosures to the minority directors. Haire testified that the continuation of this action would not prevent Anchor from continuing to serve effectively as adviser to the Fund (284A-286A). In sharp contrast to his prior statement to the minority directors, Haire testified: "I have never at any time had any doubt that we could continue to effectively serve the fund" (287A). Haire further testified that he had never

even considered the "possibility" of Anchor's advisory contract being terminated in the event the present action were allowed to proceed (288A) and observed that stockholder actions are a part of doing business in the mutual fund industry (326A).

When paragraph 22(c) of Kendall's affidavit, a major cornerstone of the "business judgment" relied on by defendants (48A), was read to Haire at his deposition, he testified in substance that he disagreed with it (284A-287A). Haire never communicated this to the minority directors, despite the fact that it was Haire himself who in December of 1974 stressed to the minority directors the supposedly dire consequences that further prosecution of this action would have for Anchor (288A). Rather, Haire and the other defendants utilized the misinformed determination of the minority directors by presenting it to the court below as a ground for dismissing this action without judicial scrutiny of the merits.

The fact that the minority directors based their judgment on reasons given by defendant Haire which subsequently were substantially disavowed by him demonstrates not only that the alleged reasons have no merit, but also that the minority directors were misled in exercising their "business judgment." As Judge Frankel observed in Papilsky v. Berndt, CCH Fed.Sec.L.Rep. ¶95,627 at 90,133 (S.D.N.Y. 1976):

"[T]he picture that emerges is one of [the adviser] funneling to the Board business reasons why one or another method of recapture would be a poor idea -- business reasons that, we now are told, should not have precluded recapture"

This absence of full and adequate disclosure, and the making of material misstatements to the minority directors, precluded the exercise of any "reasonable business judgment." Fogel v. Chestnutt, supra at 750.

The legal adequacy of the disclosure made to the disinterested directors was further impaired by the fact that they were advised, in connection with their deliberations, by the Fund's litigation counsel, Eugene P. Souther, who was not disinterested within the applicable statutory definition. The influence of Mr. Souther's participation in the minority's deliberations and determination was significant. As Ms. Robichaud, one of the minority directors, testified, Judge Fuld's role was primarily to examine appellants' claims while Mr. Souther's advice focused on the practical implications of procedural alternatives (894A-895A).

Although none of the minority directors played any role in the retention of Mr. Souther's law firm, they nevertheless understood that Mr. Souther and his firm were available to advise them in connection with their decision (584A). Mr. Souther was present at the two meetings held by the minority directors and rendered substantial advice, the effect of which could only have been to discourage the minority directors from allowing this suit to go forward.

For example, the minutes of the December 18, 1974 meeting, prepared by Mr. Souther as secretary, confirm that his remarks at that meeting amounted, in substance, to a statement of

reasons why the Fund would have little to gain if this case were permitted to go forward (106A-107A).

Mr. Souther also played a prominent role at the January 6, 1975 meeting at which the minority directors actually determined to seek dismissal of this action. At that meeting he presented to the minority directors a memorandum outlining the procedures that would have to be undertaken if the Fund were to terminate Anchor's advisory contract and seek a new adviser (126A-127A, 199A-204A). As previously stated, the directors believed, on the basis of the erroneous statements of defendant Haire, that if the present case were allowed to continue, Anchor would have to be terminated as an adviser. Mr. Souther's memorandum was prompted by a question from the minority directors concerning the procedures to be followed in the event Anchor had to be terminated (616A-617A, 891A-892A). Mr. Souther's memorandum clearly had the effect of discouraging the minority directors from recommending action against Anchor (892A-893A). Amidst his description of the complexities, hardships and potentially harmful consequences of such a move, Mr. Souther also raised the spectre of a proxy contest, pointing out the possibility that some shareholders might contest the selection of a new adviser and might nominate for election their own slate of directors (202A). He also said it was possible that a substantial number of shares would be redeemed by virtue of a proxy contest and that such a contest might make it difficult for the Fund to find an established adviser (202A).

Mr. Souther's firm, Seward & Kissel, is counsel to the Fund in this litigation. His firm also represented the Fund in two matters in 1967 (172A) and thereafter in Gordon v. Fundamental Investors, Inc., 362 F. Supp. 41 (S.D.N.Y. 1973). Both as of the time that the minority directors undertook to make a determination regarding this action and as of the date of their determination, Mr. Souther's firm was acting as legal counsel to the Fund in this action. Prior to that, Mr. Souther's firm had, since early 1973, continuously represented the Fund in the present action.

Under Section 2(a)(19)(A)(iv) of the Investment Company Act an "interested person" of an investment company includes "any person or partner or employee of any person who at any time since the beginning of the last two fiscal years of such company has acted as legal counsel for such company." Since his firm was acting as legal counsel for the Fund as of all the relevant dates, Mr. Souther was an "interested person" within the statutory definition and could not be deemed a disinterested counsel under the statute.

In Papilsky v. Berndt, supra, a law firm gave legal advice both to the adviser and the fund's board regarding the recapture of brokerage commissions. Judge Frankel concluded that counsel "in advising both Lord, Abbett and Affiliated Fund, was counseling people with contrary interests" (Id. at 90,133; see also Matter of Kelly, 23 N.Y. 2d 368, 374-79 (1968)).

In the present case, while Mr. Souther did not represent the Fund's adviser, he nevertheless did counsel clients with different interests -- on the one hand, the Fund, dominated by its adviser

and controlled by named defendants in this action, and on the other hand, the minority directors, purportedly representing the shareholders, who were supposed to act independently of the controlling defendants. Under such circumstances, the legal adequacy of disclosure made to the disinterested directors in connection with their deliberations cannot be sustained.

POINT VIII

AS TO THE PARTICULAR QUESTION THEY WERE ASKED TO DECIDE (IN WHICH THE FUND'S ADVISER AND THE CONTROLLING DEFENDANTS HAD SUBSTANTIAL FINANCIAL INTERESTS ADVERSE TO THE FUND'S SHAREHOLDERS), THE MINORITY DIRECTORS WERE NOT TRULY INDEPENDENT AND WERE SUBJECT TO CONFLICTING LOYALTIES.

The issue here is independence, not bad faith. The district court, while acknowledging the distinction in theory, failed to apply it in its decision. The conclusion that the minority directors were not truly independent, as to the question they were asked to decide, does not entail any finding of conscious bias or dishonesty. It simply means that on the particular issue put before them, in which the dominant insider defendants had a substantial adverse interest, neither the minority directors, nor anyone else in their position, could realistically be expected to exercise their judgment free of the pervasive influence of the Fund's investment adviser and the other controlling defendants.

This is not a case where Fund directors are asked to make a business judgment involving outsiders. This is a case where selected representatives of a pervasively controlled entity,

a mutual fund, are asked to decide whether those in control should be exposed to substantial liability.*

Whatever theoretical independence representatives of the Fund, under the best of circumstances, might have as regards whether to sue outsiders, it is illusory to speak of such independence as between, on the one hand, a dominant adviser and controlling defendants comprising an absolute majority of a Fund's board and, on the other hand, five minority directors of what is, in substance, a controlled shell (169A-170A).

Defendants have not presented any evidence whatsoever that the minority directors were truly independent. Instead, defendants' position is a sterile and hypertechnical one, namely, that the minority directors have no material business or professional relationships with any of the defendants, apart from the fact that they are directors in the Anchor group of funds (See Investment Company Act §§2(a)(19)(A)(vi) and (B)(vi)).

The statutory definition of a "disinterested" director in no way addresses the issue of the true relationship of the minority directors to the defendant directors on the Fund's board as to a question in which those in control are adversely interested. For example, defendants Kemmerer and Phillips, who also happen to be "disinterested" directors, obviously could not be deemed independent for purposes of seeking the dismissal of this litigation, notwithstanding the fact that the statutory definition

* The seriousness of the case to Anchor is clear from the fact that Haire said in December 1974 he was not sure whether Anchor's entire networth would be sufficient to respond in damages if a judgment were entered against it in the present case (114A).

of a "disinterested" director applies to them in precisely the same manner and to the same extent as to the five minority directors.

As to the realities, the Wharton Report recognized that, where management controls the selection process, "unaffiliated," now "disinterested," directors of mutual funds cannot be truly independent (Wharton Report at 465-66). This is consistent with the fact that mutual funds have always been subject to pervasive control by their investment advisers (168A-169A), a reality recognized by Congress and reflected in the Investment Company Act. See Nutt, "A Study of Mutual Fund Independent Directors," 120 U. Pa. L. Rev. 179, 216 (1971-72).^{*} Similarly, in Fogel v. Chestnutt, supra at 750, this Court itself observed:

"Under the best of circumstances there is bound to be doubt about the independence of the 'unaffiliated' or now the 'disinterested' director...."

In the present case, the defendants named in this action at all relevant times controlled the director election process and the proxy machinery of the Fund. The minority directors' continued tenure as directors was within the control of defendants. The minority directors could not realistically contest Anchor and the other defendants in a matter in which Anchor and the other defendants have as much at stake as in this case without exposing themselves to removal. Neither independence, nor the appearance of independence, is possible under such circumstances.

In an affidavit filed with the district court,

^{*} The fund in the present case is typical. Its principal officers are Anchor personnel and it is totally dependent on Anchor for its administrative requirements, including office space, clerical personnel, etc. (136A, 194A).

James C. Sargent, a former member of the Securities and Exchange Commission, expressed essentially the same view on the basis of his own experience:

"If a quorum of outside directors, comprising a minority of a mutual fund's board, is asked to make a determination on behalf of the fund and that determination might adversely affect the economic interests of the remaining directors, who comprise an absolute majority of the fund's board, and who also thereby control the fund's proxy machinery, the minority directors, in my opinion, cannot be considered truly 'independent' in any meaningful sense. Under such circumstances, whether or not the minority directors attempt to make their determination in good faith, the fact nevertheless remains that the majority directors would have the unchallengeable power to nominate, in connection with the fund's next stockholders' meeting, a slate of directors which would exclude the minority directors and thereby, for all intents and purposes, terminate their directorships" (169A-170A).

All five minority directors were nominated for their directorships by directors named as defendants in this action, after screening by a qualifications committee consisting, in all cases, of at least a majority of directors named as defendants in this action, including the chief executive of Anchor (175A-185A, Document 84 of Index to Record, Pls. Exhs. 5, 6, 13, 14, 21 and 22). The minority directors serve on the boards of all funds in the Anchor group (except for one director who does not sit on the board of one fund) (232A). For their services they are paid compensation in the range of \$11,000 to \$13,000 per year (186A-190A).

Discovery has revealed that several of the minority directors had longstanding relationships with various defendants

which substantially pre-dated their election to the board (221A-222A, 470A, 475A-476A, 480A, 671A-673A, 920A-921A, 1064A-1066A). In addition, the minority directors, as directors, work and associate with the very persons whom they were asked to judge. Where people work together in that fashion, it is unrealistic to believe that one can "independently" or "disinterestedly" determine whether his fellow directors should be sued for millions of dollars for gross misconduct and abuse of trust. Such a procedure certainly does not promote the congressional policy of eradicating insider abuses in the mutual fund industry.

The Fund's board, at a meeting held October 28, 1970, determined to commence suit against Goldman, Sachs, which was done in November, 1970. With respect to Anchor --

"The Board of Directors of the Fund concluded, for a number of reasons, not to pursue an action against Anchor or its officers at that time but to defer such a decision until after the determination of the Fund's suit against Goldman, Sachs" (30A; see also 31A).

It was thus clear as of the end of October, 1970 that once the Goldman, Sachs litigation was resolved, a decision would be made with respect to what action, if any, the Fund would take against Anchor, Haire and others (123A-124A). The directors qualifications committee was subsequently created in July 1971 upon the recommendation of defendant Haire (174A). The board creating the committee consisted entirely of defendants and the committee at its inception consisted of three directors -- Haire, Burks and Phillips -- all of whom also are defendants in this

action (173A-174A). Three of the five minority directors were selected by this committee after commencement of the present action in February 1973 (180A, 182A, 184A).

The following table shows the composition of the directors qualifications committee as of the time of the selection of each of the minority directors. As is evident from the table, in every instance except for Kendall, the committee consisted totally of defendants. In Kendall's case, the committee included two defendants.

<u>Minority Directors</u>	<u>Members of Directors Qualifications Committee</u>
1. Laun	Defendant Haire Defendant Burks Defendant Phillips
2. O'Connor	Defendant Haire Defendant Burks Defendant Phillips
3. Stephens	Defendant Haire Defendant Kemmerer Defendant Hopkins
4. Robichaud	Defendant Haire Defendant Kemmerer Defendant Hopkins
5. Kendall	Defendant Haire Defendant Kemmerer Ms. Robichaud

(See 195A, Document 84 of Index to Record, Pls. Exhs. 5, 6, 13, 14, 21 and 22.)

The following table shows the composition of the board of directors of the Fund which nominated each of the minority directors for membership on the board (and in Laun's case, voted directly for his election).

Minority Directors

1. Laun

2. O'Connor

3. Stephens

4. Robichaud

Members of the Nominating
Board of Directors

Defendant Haire
Defendant Burr
Defendant Hutchison
Defendant Phillips
Defendant Kemmerer
Defendant Burks
Defendant Hopkins
Defendant Monroney
Defendant Wade

Defendant Haire
Defendant Burr
Defendant Hutchison
Defendant Kemmerer
Defendant Burks
Defendant Hopkins
Defendant Wade
Mr. Martin -- President of
Anchor
Mr. Laun

Defendant Haire
Defendant Burr
Defendant Hutchison
Defendant Phillips
Defendant Kemmerer
Defendant Hopkins
Defendant Wade
Mr. Martin -- President of
Anchor
Mr. Laun
Mrs. O'Connor

Defendant Haire
Defendant Burr
Defendant Hutchison
Defendant Phillips
Defendant Kemmerer
Defendant Hopkins
Defendant Wade
Mr. Martin -- President of
Anchor
Mr. Laun
Mrs. O'Connor
Mr. Taylor

Minority Directors

5. Kendall

Members of the Nominating
Board of Directors

Defendant Haire*
Defendant Burr*
Defendant Hutchison*
Defendant Kemmerer
Defendant Phillips
Mr. Martin -- President of
Anchor*

Mr. Laun
Mrs. O'Connor
Mr. Stephens
Ms. Robichaud

(See 175A-185A.)

Under the circumstances, the minority directors, we submit, could not even meet the standard of impartiality required of a juror (see Commonwealth Corp. v. Casualty Co., 393 U.S. 145 (1968), reh. denied, 393 U.S. 1112 (1969)), let alone the standard of advocacy required of them as special representatives of the shareholders purporting to guard against excesses by dominant insiders. The watchdog function assigned to outside directors by Congress could hardly have been realized where their very continuation in office was subject to the absolute control of precisely those whose fate they were deciding. True impartiality, let alone advocacy for the shareholders, is impossible where minority directors are asked to review the fiduciary conduct of majority directors with whom they have substantial relationships and who placed them and keep them in office.

The minority directors, as fiduciaries, were faced with conflicting loyalties -- to the shareholders, on the one hand, and to their friends and associates on the board, on the other hand.

* Abstained from voting. The four abstaining directors were affiliated with Anchor. However, Haire, as a member of the qualifications committee, had already voted for Kendall and, indeed, had recommended him in the first instance (377A).

They were in no position to make a truly independent business judgment. See 3A Fletcher, Cyclopedia Corporations §1039, p. 38 (Perm. ed. 1975).

The rationale for the requirement of undivided loyalty was set forth by this Court in York v. Guaranty Trust Co. of New York, 143 F.2d 503, 514 n.15a (2d Cir. 1944), rev'd on other grounds, 326 U.S. 99 (1945):

"The fiduciary has two paramount obligations: responsibility and loyalty. * * * They lie at the very foundation of our whole system of free private enterprise and are as fresh and significant today as when they were formulated decades ago. * * * While there is a high moral purpose implicit in this transcendent fiduciary principle of undivided loyalty, it has back of it a profound understanding of human nature and of its frailties. It actually accomplishes a practical, beneficent purpose. It tends to prevent a clouded conception of fidelity that blurs the vision. It preserves the free exercise of judgment uncontaminated by the dross of divided allegiance or self-interest. It prevents the operation of an influence that may be indirect but that is all the more potent for that reason."

See also: City Bank Farmers Trust Co. v. Cannon, 291 N.Y. 125, 132 (1943); Ripley v. Internat. Rys. of Cent. America, 8 App. Div. 2d 310, 317 (1st Dep't 1959), aff'd, 8 N.Y.2d 430 (1960).

Faced with conflicting loyalties, including substantial remuneration, a history of personal relationships with various defendants, defendants' absolute control over the Fund's proxy machinery and given the Fund's complete operational dependence

on Anchor, the minority directors, regardless of whether they attempted to act in good faith, were not, as a matter of law, in a position to exercise undivided loyalty to the Fund's shareholders, impartiality or independence, despite all protests and rhetoric to the contrary.

Finally, if the concept of "business judgment" were applicable at all to this case, we submit that defendants, all of whom are adversely interested fiduciaries, should be required to sustain their delegation of authority to the minority directors and should have the burden of proof, by clear and convincing evidence, on the issue of true independence. As fiduciaries, corporate directors have the burden of proof with respect to transactions in which they and their corporation have conflicting interests and which involve a breach of fiduciary duty. E.g., Pepper v. Litton, 308 U.S. 295, 306 (1939); Perlman v. Feldmann, 219 F.2d 173, 178 (2d Cir.), cert. denied, 349 U.S. 952 (1955). See also the amicus brief (p. 37 n.47) of the Securities and Exchange Commission in Tannenbaum v. Zeller, supra, which stated:

"Our experience with respect to the question of actual independence of directors leads us to suggest that the burden of demonstrating independence of action be a heavy and convincing one on the defendant."

Defendants have not approached, let alone met, that standard.

Conclusion

The judgment and orders appealed from should be reversed and the case remanded to the district court.

Dated: New York, N.Y.
April 15, 1977

Respectfully submitted,
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ADDENDUM

Investment Company Act

§1. Findings and declaration of policy

...

(b) Upon the basis of facts disclosed by the record and reports of the Securities and Exchange Commission made pursuant to section 79z-4 of this title, and facts otherwise disclosed and ascertained, it is declared that the national public interest and the interest of investors are adversely affected—

(1) when investors purchase, pay for, exchange, receive dividends upon, vote, refrain from voting, sell, or surrender securities issued by investment companies without adequate, accurate, and explicit information, fairly presented, concerning the character of such securities and the circumstances, policies, and financial responsibility of such companies and their management;

(2) when investment companies are organized, operated, managed, or their portfolio securities are selected, in the interest of directors, officers, investment advisers, depositors, or other affiliated persons thereof, in the interest of underwriters, brokers, or dealers, in the interest of special classes of their security holders, or in the interest of other investment companies or persons engaged in other lines of business, rather than in the interest of all classes of such companies' security holders;

(3) when investment companies issue securities containing inequitable or discriminatory provisions, or fail to protect the preferences and privileges of the holders of their outstanding securities;

(4) when the control of investment companies is unduly concentrated through pyramiding or inequitable methods of control, or is inequitably distributed, or when investment companies are managed by irresponsible persons;

(5) when investment companies, in keeping their accounts, in maintaining reserves, and in computing their earnings and the asset value of their outstanding securities, employ unsound or misleading methods, or are not subjected to adequate independent scrutiny;

(6) when investment companies are reorganized, become inactive, or change the character of their business, or when the control or management thereof is transferred, without the consent of their security holders;

(7) when investment companies by excessive borrowing and the issuance of excessive amounts of senior securities increase unduly the speculative character of their junior securities; or

(8) when investment companies operate without adequate assets or reserves.

It is declared that the policy and purposes of this subchapter, in accordance with which the provisions of this subchapter shall be interpreted, are to mitigate and, so far as is feasible, to eliminate the conditions enumerated in this section which adversely affect the national public interest and the interest of investors.

* * *

§ 2. Definitions

(a) When used in this subchapter, unless the context otherwise requires—

...

(19) "Interested person" of another person means—

(A) when used with respect to an investment company—

(i) any affiliated person of such company,

(ii) any member of the immediate family of any natural person who is an affiliated person of such company,

(iii) any interested person of any investment adviser of or principal underwriter for such company,

(iv) any person or partner or employee of any person who at any time since the beginning of the last two fiscal years of such company has acted as legal counsel for such company,

(v) any broker or dealer registered under the Securities Exchange Act of 1934 or any affiliated person of such a broker or dealer, and

(vi) any natural person whom the Commission by order shall have determined to be an interested person by reason of having had, at any time since the beginning of the last two fiscal years of such company, a material business or professional relationship with such company or with the principal executive officer of such company or with any other investment company having the same investment adviser or principal underwriter or with the principal executive officer of such other investment company:

Provided, That no person shall be deemed to be an interested person of an investment company solely by reason of (aa) his being a member of its board of directors or advisory board or an owner of its securities, or (bb) his membership in the immediate family of any person specified in clause (aa) of this proviso.

* * *

§ 13. Changes in investment policy

(a) No registered investment company shall, unless authorized by the vote of a majority of its outstanding voting securities—

...

(3) deviate from its policy in respect of concentration of investments in any particular industry or group of industries as recited in its registration statement, deviate from any investment policy which is changeable only if authorized by shareholder vote, or deviate from any policy recited in its registration statement pursuant to section 80a—8(b) (3) of this title:

* * *

§15. Contracts of advisers and underwriters

...

(c) In addition to the requirements of subsections (a) and (b) of this section, it shall be unlawful for any registered investment company having a board of directors to enter into, renew, or perform any contract or agreement, written or oral, whereby a person undertakes regularly to serve or act as investment adviser of or principal underwriter for such company, unless the terms of such contract or agreement and any renewal thereof have been approved by the vote of a majority of directors, who are not parties to such contract or agreement or interested persons of any such party, cast in person at a meeting called for the purpose of voting on such approval. It shall be the duty of the directors of a registered investment company to request and evaluate, and the duty of an investment adviser to such company to furnish, such information as may reasonably be necessary to evaluate the terms of any contract whereby a person undertakes regularly to serve or act as investment adviser of such company. It shall be unlawful for the directors of a registered investment company, in connection with their evaluation of the terms of any contract whereby a person undertakes regularly to serve or act as investment adviser of such company, to take into account the purchase price or other consideration any person may have paid in connection with a transaction of the type referred to in paragraph (1), (3), or (4) of subsection (f) of this section.

* * *

§16. Board of directors; election; term vacancies; trustees of common-law trusts

...

(b) Any vacancy on the board of directors of a registered investment company which occurs in connection with compliance with section 80a—15(f)(1)(A) of this title and which must be filled by a person who is not an interested person of either party to a transaction subject to section 80a—15(f)(1)(A) of this title shall be filled only by a person

(1) who has been selected and proposed for election by a majority of the directors of such company who are not such interested persons, and (2) who has been elected by the holders of the outstanding voting securities of such company, except that in the case of the death, disqualification, or bona fide resignation of a director selected and elected pursuant to clauses (1) and (2) of this subsection (b), the vacancy created thereby may be filled as provided in subsection (a) of this section.

* * *

§17. Transactions of certain affiliated persons and underwriters

(a) It shall be unlawful for any affiliated person or promoter of or principal underwriter for a registered investment company (other than a company of the character described in section 80a—12(d)(3)(A) and (B) of this title), or any affiliated person of such a person, promoter, or principal underwriter, acting as principal—

(1) knowingly to sell any security or other property to such registered company or to any company controlled by such registered company, unless such sale involves solely (A) securities of which the buyer is the issuer, (B) securities of which the seller is the issuer and which are part of a general offering to the holders of a class of its securities, or (C) securities deposited with the trustee of a unit investment trust or periodic payment plan by the depositor thereof;

(2) knowingly to purchase from such registered company, or from any company controlled by such registered company, any security or other property (except securities of which the seller is the issuer); or

(3) to borrow money or other property from such registered company or from any company controlled by such registered company (unless the borrower is controlled by the lender) except as permitted in section 80a—21(b) of this title.

(b) Notwithstanding subsection (a) of this section, any person may file with the Commission an application for an order exempting a proposed transaction of the applicant from one or more provisions of said subsection. The Commission shall grant such application and issue such order of exemption if evidence establishes that—

(1) the terms of the proposed transaction, including the consideration to be paid or received, are reasonable and fair and do not involve overreaching on the part of any person concerned;

(2) the proposed transaction is consistent with the policy of each registered investment company concerned, as recited in its registration statement and reports filed under this subchapter; and

(3) the proposed transaction is consistent with the general purposes of this subchapter.

(c) Notwithstanding subsection (a) of this section, a person may, in the ordinary course of business, sell to or purchase from any company merchandise or may enter into a lessor-lessee relationship with any person and furnish the services incident thereto.

(d) It shall be unlawful for any affiliated person of or principal underwriter for a registered investment company (other than a company of the character described in section 80a—12(d) (3) (A) and (B) of this title), or any affiliated person of such a person or principal underwriter, acting as principal to effect any transaction in which such registered company, or a company controlled by such registered company, is a joint or a joint and several participant with such person, principal underwriter, or affiliated person, in contravention of such rules and regulations as the Commission may prescribe for the purpose of limiting or preventing participation by such registered or controlled company on a basis different from or less advantageous than that of such other participant. Nothing contained in this subsection shall be deemed to preclude any affiliated person from acting as manager of any underwriting syndicate or other group in which such registered or controlled company is a participant and receiving compensation therefor.

(e) It shall be unlawful for any affiliated person of a registered investment company, or any affiliated person of such person—

(1) acting as agent, to accept from any source any compensation (other than a regular salary or wages from such registered company) for the purchase or sale of any property to or for such registered company or any controlled company thereof, except in the course of such person's business as an underwriter or broker; or

(2) acting as broker, in connection with the sale of securities to or by such registered company or any controlled company thereof, to receive from any source a commission, fee, or other remuneration for effecting such transaction which exceeds (A) the usual and customary broker's commission if the sale is effected on a securities exchange, or (B) 2 per centum of the sales price if the sale is effected in connection with a secondary distribution of such securities, or (C) 1 per centum of the purchase or sale price of such securities if the sale is otherwise effected unless the Commission shall, by rules and regulations or order in the public interest and consistent with the protection of investors, permit a larger commission.

(f) Every registered management company shall place and maintain its securities and similar investments in the custody of (1) a bank or banks having the qualifications prescribed in paragraph (1) of section 80a-26(a) of this title for the trustees of unit investment trusts; or (2) a company which is a member of a national securities exchange as defined in the Securities Exchange Act of 1934, subject to such rules and regulations as the Commission may from time to time prescribe for the protection of investors; or (3) such registered company, but only in accordance with such rules and regulations or orders as the Commission may from time to time prescribe for the protection of investors. Subject to such rules, regulations, and orders as the Commission may adopt as necessary or appropriate for the protection of investors, a registered management company or any such custodian, with the consent of the registered management company for which it acts as custodian, may deposit all or any part of the securities owned by such registered management company in a system for the central handling of securities established by a national securities exchange or national securities association registered with the Commission under the Securities Exchange Act of 1934, or such other person as may be permitted by the Commission, pursuant to which system all securities of any particular class or series of any issuer deposited within the system are treated as fungible and may be transferred or pledged by bookkeeping entry without physical delivery of such securities. Rules, regulations, and orders of the Commission under this subsection, among other things, may make appropriate provision with respect to such matters as the earmarking, segregation, and hypothecation of such securities and investments, and may provide for or require periodic or other inspections by any or all of the following: independent public accountants, employees and agents of the Commission, and such other persons as the Commission may designate. No such member which trades in securities for its own account may act as custodian except in accordance with rules and regulations prescribed by the Commission for the protection of investors. If a registered company maintains its securities and similar investments in the custody of a qualified bank or banks, the cash proceeds from the sale of such securities and similar investments and other cash assets of the company shall likewise be kept in the custody of such a bank or banks, or in accordance with such rules and regulations or orders as the Commission may from time to time prescribe for the protection of investors, except that such a registered company may maintain a checking account in a bank or banks having the qualifications prescribed in paragraph (1) of section 80a-26(a) of this title for the trustees of unit investment trusts with the balance of such account or the aggregate balances of such accounts at no time in excess of the amount of the fidelity bond, maintained pursuant to subsection (g) of this section, covering the officers or employees authorized to draw on such account or accounts.

(g) The Commission is authorized to require by rules and regulations or orders for the protection of investors that any officer or employee of a registered management investment company who may singly, or jointly with others, have access to securities or funds of any registered company, either directly or through authority to draw upon such funds or to direct generally the disposition of such securities (unless the officer or employee has such access solely through his position as an officer or employee of a bank) be bonded by a reputable fidelity insurance company against larceny and embezzlement in such reasonable minimum amounts as the Commission may prescribe.

(h) After one year from the effective date of this subchapter, neither the charter, certificate of incorporation, articles of association, indenture of trust, nor the by-laws of any registered investment company, nor any other instrument pursuant to which such a company is organized or administered, shall contain any provision which protects or purports to protect any director or officer of such company against any liability to the company or to its security holders to which he would otherwise be subject by reason of willful misfeasance, bad faith, gross negligence or reckless disregard of the duties involved in the conduct of his office.

In the event that any such instrument does not at the effective date of this chapter comply with the requirements of this subsection and is not amended to comply therewith prior to the expiration of said one year, such company may nevertheless continue to be a registered investment company and shall not be deemed to violate this subsection if prior to said expiration date each such director or officer shall have filed with the Commission a waiver in writing of any protective provision of the instrument to the extent that it does not comply with this subsection, and each such person subsequently elected or appointed shall before assuming office file a similar waiver.

(i) After one year from the effective date of this subchapter no contract or agreement under which any person undertakes to act as investment adviser of, or principal underwriter for, a registered investment company shall contain any provision which protects or purports to protect such person against any liability to such company or its security holders to which he would otherwise be subject by reason of willful misfeasance, bad faith, or gross negligence, in the performance of his duties, or by reason of his reckless disregard of his obligations and duties under such contract or agreement.

In the event that any such contract or agreement does not at the effective date of this chapter comply with the requirements of this subsection and is not amended to comply therewith prior to the expiration of said one year, this subsection shall not be deemed to have been violated if prior to said expiration date each such investment adviser or principal underwriter shall have filed with the Commission a waiver in writing of any protective provision of the contract or agreement to the extent that it does not comply with this subsection.

(j) It shall be unlawful for any affiliated person of or principal underwriter for a registered investment company or any affiliated person of an investment adviser of or principal underwriter for a registered investment company, to engage in any act, practice, or course of business in connection with the purchase or sale, directly or indirectly, by such person of any security held or to be acquired by such registered investment company in contravention of such rules and regulations as the Commission may adopt to define, and prescribe means reasonably necessary to prevent, such acts, practices, or courses of business as are fraudulent, deceptive or manipulative. Such rules and regulations may include requirements for the adoption of codes of ethics by registered investment companies and investment advisers of, and principal underwriters for, such investment companies establishing such standards as are reasonably necessary to prevent such acts, practices, or courses of business.

* * *

§32. Accountants and auditors

(a) It shall be unlawful for any registered management company or registered face-amount certificate company to file with the Commission any financial statement signed or certified by an independent public accountant, unless—

(1) such accountant shall have been selected at a meeting held within thirty days before or after the beginning of the fiscal year or before the annual meeting of stockholders in that year by the vote, cast in person, of a majority of those members of the board of directors who are not interested persons of such registered company;

(2) such selection shall have been submitted for ratification or rejection at the next succeeding annual meeting of stockholders if such meeting be held, except that any vacancy occurring between annual meetings, due to the death or resignation of the accountant, may be filled by the vote of a majority of those members of the board of directors who are not interested persons of such registered company, cast in person at a meeting called for the purpose of voting on such action;

(3) the employment of such accountant shall have been conditioned upon the right of the company by vote of a majority of the outstanding voting securities at any meeting called for the purpose to terminate such employment forthwith without any penalty; and

(4) such certificate or report of such accountant shall be addressed both to the board of directors of such registered company and to the security holders thereof.

If the selection of an accountant has been rejected pursuant to paragraph (2) or his employment terminated pursuant to paragraph (3), the vacancy so occurring may be filled by a vote of a majority of the outstanding voting securities, either at the meeting at which the rejection or termination occurred or, if not so filled, at a subsequent meeting which shall be called for the purpose. In the case of a common-law trust of the character described in section 80a—16(c) of this title, no ratification of the employment of such accountant shall be required but such employment may be terminated and such accountant removed by action of the holders of record of a majority of the outstanding shares of beneficial interest in such trust in the same manner as is provided in section 80a—16(c) of this title in respect of the removal of a trustee, and all the provisions therein contained as to the calling of a meeting shall be applicable. In the event of such termination and removal, the vacancy so occurring may be filled by action of the holders of record of a majority of the shares of beneficial interest either at the meeting, if any, at which such termination and removal occurs, or by instruments in writing filed with the custodian, or if not so filed within a reasonable time then at a subsequent meeting which shall be called by the trustees for the purpose. The provisions of paragraph (4) of section 80a—2(a) of this title as to a majority shall be applicable to the vote cast at any meeting of the shareholders of such a trust held pursuant to this subsection.

* * *

§36. [Effective prior to December 14, 1970]

The Commission is authorized to bring an action in the proper district court of the United States, or in the United States court of any territory or other place subject to the jurisdiction of the United States, alleging that a person serving or acting in one or more of the following capacities has been guilty, after August 22, 1940, and within five years of the commencement of the action of gross misconduct or gross abuse of trust in respect of any registered investment company for which such person so serves or acts--

(1) as officer, director, member of any advisory board, investment adviser, or depositor; or

(2) as principal underwriter, if such registered company is an open-end company, unit investment trust, or face-amount certificate company.

If the Commission's allegations of such gross misconduct or gross abuse of trust are established, the court shall enjoin such person from acting in such capacity or capacities either permanently or for such period of time as it in its discretion shall deem appropriate.

* * *

§36. [Effective December 14, 1970]

Breach of fiduciary duty—Civil actions by Commission; jurisdiction; allegations; injunctive or other relief

(a) The Commission is authorized to bring an action in the proper district court of the United States, or in the United States court of any territory or other place subject to the jurisdiction of the United States, alleging that a person serving or acting in one or more of the following capacities has engaged within five years of the commencement of the action or is about to engage in any act or practice constituting a breach of fiduciary duty involving personal misconduct in respect of any registered investment company for which such person so serves or acts—

(1) as officer, director, member of any advisory board, investment adviser, or depositor; or

(2) as principal underwriter, if such registered company is an open-end company, unit investment trust, or face-amount certificate company.

If such allegations are established, the court may enjoin such persons from acting in any or all such capacities either permanently or temporarily and award such injunctive or other relief against such person as may be reasonable and appropriate in the circumstances, having due regard to the protection of investors and to the effectuation of the policies declared in section 80a—1(b) of this title.

Compensation or payments as basis of fiduciary duty; civil actions by Commission or security holder; burden of proof; judicial consideration of director or shareholder approval; persons liable; extent of liability; exempted transactions; jurisdiction; finding restriction

(b) For the purposes of this subsection, the investment adviser of a registered investment company shall be deemed to have a fiduciary duty with respect to the receipt of compensation for services, or of payments of a material nature, paid by such registered investment company, or by the security holders thereof, to such investment adviser or any affiliated person of such investment adviser. An action may be brought under this subsection by the Commission, or by a security holder of such registered investment company on behalf of such company, against such investment adviser, or any affiliated person of such investment adviser, or any other person enumerated in subsection (a) of this section who has a fiduciary duty concerning such compensation or payments, for breach of fiduciary duty in respect of such compensation or payments paid by such registered investment company or by the security holders thereof to such investment adviser or person. With respect to any such action the following provisions shall apply:

(1) It shall not be necessary to allege or prove that any defendant engaged in personal misconduct, and the plaintiff shall have the burden of proving a breach of fiduciary duty.

(2) In any such action approval by the board of directors of such investment company of such compensation or payments, or of contracts or other arrangements providing for such compensation or payments, and ratification or approval of such compensation or payments, or of contracts or other arrangements providing for such compensation or payments, by the shareholders of such investment company, shall be given such consideration by the court as is deemed appropriate under all the circumstances.

(3) No such action shall be brought or maintained against any person other than the recipient of such compensation or payments, and no damages or other relief shall be granted against any person other than the recipient of such compensation or payments. No award of damages shall be recoverable for any period prior to one year before the action was instituted. Any award of damages against such recipient shall be limited to the actual damages resulting from the breach of fiduciary duty and shall in no event exceed the amount of compensation or payments received from such investment company, or the security holders thereof, by such recipient.

(4) This subsection shall not apply to compensation or payments made in connection with transactions subject to section 80a—17 of this title, or rules, regulations, or orders thereunder, or to sales loans for the acquisition of any security issued by a registered investment company.

(5) Any action pursuant to this subsection may be brought only in an appropriate district court of the United States.

(6) No finding by a court with respect to a breach of fiduciary duty under this subsection shall be made a basis (A) for a finding of a violation of this subchapter for the purposes of sections 80a—9 and 80a—48 of this title, section 78o of this title, or section 80b—3 of this title, or (B) for an injunction to prohibit any person from serving in any of the capacities enumerated in subsection (a) of this section.

Investment Advisers Act

§206. Prohibited transactions by investment advisers

It shall be unlawful for any investment adviser, by use of the mails or any means or instrumentality of interstate commerce, directly or indirectly—

(1) to employ any device, scheme, or artifice to defraud any client or prospective client;

(2) to engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client;

(3) acting as principal for his own account, knowingly to sell any security to or purchase any security from a client, or acting as broker for a person other than such client, knowingly to effect any sale or purchase of any security for the account of such client, without disclosing to such client in writing before the completion of such transaction the capacity in which he is acting and obtaining the consent of the client to such transaction. The prohibitions of this paragraph shall not apply to any transaction with a customer of a broker or dealer if such broker or dealer is not acting as an investment adviser in relation to such transaction;

(4) to engage in any act, practice, or course of business which is fraudulent, deceptive, or manipulative. The Commission shall, for the purposes of this paragraph (4) by rules and regulations define, and prescribe means reasonably designed to prevent, such acts, practices, and courses of business as are fraudulent, deceptive, or manipulative.

Federal Rules of Civil Procedure

Rule 23.1. Derivative Actions by Shareholders

In a derivative action brought by one or more shareholders or members to enforce a right of a corporation or of an unincorporated association, the corporation or association having failed to enforce a right which may properly be asserted by it, the complaint shall be verified and shall allege (1) that the plaintiff was a shareholder or member at the time of the transaction of which he complains or that his share or membership thereafter devolved on him by operation of law, and (2) that the action is not a collusive one to confer jurisdiction on a court of the United States which it would not otherwise have. The complaint shall also allege with particularity the efforts, if any, made by the plaintiff to obtain the action he desires from the directors or comparable authority and, if necessary, from the shareholders or members, and the reasons for his failure to obtain the action or for not making the effort. The derivative action may not be maintained if it appears that the plaintiff does not fairly and adequately represent the interests of the shareholders or members similarly situated in enforcing the right of the corporation or association. The action shall not be dismissed or compromised without the approval of the court, and notice of the proposed dismissal or compromise shall be given to shareholders or members in such manner as the court directs.